IN THE

Supreme Court of The United States

OCTOBER TERM, 1977

No. 77-15

E. B. BROOKS, JR.

Petitioner,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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SPECIAL ADDENDUM TO THE PETITION

Following preparation of the Petition in chief, Petitioner learned of the decision by the Court of Appeals for the Second Circuit in *Miller* v. *New York Produce Exchange*, 550 F.2d 762 (2 Cir. 1977), and was only able to make brief reference to the decision by footnote.

Petitioner has also learned that the Trustee in Bankruptcy for the defunct brokerage firm as plaintiff in the underlying proceedings in *Miller* has since filed a Petition for Writ of Certiorari, docketed as No. 76-1592, the Petition having been filed on May 13, 1977.

The Petitioner in *Miller* seeks review of the opinion of the Court of Appeals which held that:

1. The brokerage firm as a member of the commodity exchange was bound to abide by exchange rules and regulations, 550 F.2d at 768.

2. The brokerage firm "owed a duty to act with reasonable care in maintaining the integrity of the market and that, if its own acts or omissions were a proximate cause of its injuries, it could not recover." *Ibid.*

3. That the imposition of such an *in pari delicto* defense "best promotes the objectives of the Commodity Exchange Act which are to protect commerce and the national public interest therein . . ." *Ibid.*

In so holding, the Second Circuit observed as follows:

> "Errant plaintiffs have sometimes been permitted recovery in the public interest in order to discourage *greater* wrongdoing by the defendant . . . However, where a defendant's only sin is its *failure to prevent transgressions* by the plaintiff, no benefit flows to the public from rewarding the transgressor . . . . We are not yet prepared to hold that it is in the public interest that any plaintiff should be permitted recovery 'lest the supposed wrongdoer be allowed to escape a reckon-

ing' . . .", citing *Bangor Punta Operations* v. *Bangor & Aroostook R. R.,* 417 U.S. 703, 717, 94 S. Ct. 2578 (1974), 550 F.2d at 769.

The result in *Miller* is precisely the result which Petitioner here has all along maintained should have been the result in the instant case, and the holding in *Miller* again as noted is in direct conflict with the opinion of the Circuit Court hereinbelow, in addition to the conflict of the latter with prior decisions in both the Seventh and Eighth Circuits and a review by this Honorable Court is essential to resolve the conflict of views between the Circuits.

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Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled case on March 14, 1977.

CITATION TO OPINION BELOW

The Opinion of the Court of Civil Appeals for the Fifth Circuit, printed in Appendix "A" herein is reported at 548 F. 2d 615.

JURISDICTION

The Judgment of the Circuit Court of Appeals was entered on March 14, 1977. Rehearing was denied on April 7, 1977. 550 F. 2d 1285. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Did the Court of Appeals err in holding that rules and regulations promulgated under the Commodity Exchange Act and under authority of the Commodity Exchange Commission do not have the force and effect of law.

Alternatively stated, is the Court of Appeals correct in holding that rules and regulations of the Chicago Board of Trade are not binding on its members and are the Courts of Appeals for the Seventh and Eighth Circuits correspondingly in error in having held that such rules and regulations are binding on exchange members?

2. Would willfull violation by a broker of commodity exchange rules and regulations governing extension of credit ordinarily hinder if not bar brokers' attempt to recover damages based on transactions in which the violations occurred and, if so, does the refusal by the Lower Court to permit inquiry as to whether or not broker's violations were willfull constitute fundamental error?

3. Does the customer of broker having contemporaneous knowledge of violations, and of right to complain, have affirmative duty to complain when violations are occurring or at any time thereafter prior to broker's action seeking damages causally related to those violations?

Alternatively stated, does customer consent to broker violations by failing to complain with knowledge of the right to complain?

STATUTES AND RULES INVOLVED

This case involves the Commodity Exchange Act, 7 U.S.C. § 1 et seq, more particularly § § 5, 6a(1), 6b(C) and 7a(8).

[This case also involves rules 209, 210, and 928c of the Chicago Board of Trade and its Clearinghouse as well as Regulations 1822 and 1822-A thereunder]

All are set out at length in Appendix C.

STATEMENT OF THE CASE

This is an action for money damages brought by Merrill Lynch, Pierce, Fenner & Smith, Inc., ("Merrill Lynch"), as broker against E. B. Brooks, Jr. ("Brooks"), as customer to recover the balance claimed due and owing to the broker from the customer's commodity account.

Merrill Lynch and Brooks had an extensive prior relationship as broker and customer, relating not only to trading in commodity futures, but in securities as well.

The relationship and conduct of the parties was supposed to be governed by a commody account agreement which in part provides: "Any and all transactions shall be subject to the constitution, rules, regulations, customs and usages of the exchange or market (and its clearinghouse, if any) where executed." *See Appendix D-1.*

On April 6, 1973, Brooks placed an order to go "short" in twenty-four July, 1973 soybean meal futures contracts.

On that date, by a prior sale and the placing of additional funds into his account, Brooks had a credit balance with Merrill Lynch of $51,950.00. The 24 contracts required an initial margin of $1,000.00 per contract, or $24,000.00

The price action of soybean meal futures went against short positions, such that by April 12, 1973, Brooks was due a margin call from Merrill Lynch in the sum of $10,830.00. The price action continued to go against the short position such that by April 16, 1973, his account went from a credit to a debit position, with the prior $51,950.00 in equity altogether exhausted.

Both Brooks and the Merrill Lynch account executive followed the price action of soybean meal contracts daily and indeed on most market days, Brooks was in the Merrill Lynch offices reviewing his position personally with the Merrill Lynch account executive.

Although during the period from April 16, 1973 to April 30, 1973, Brooks asked his account executive on one or more occasions why he was not getting a margin call, he did not receive a margin call from Merrill Lynch until late in the day on May 1, 1973, when the margin necessary to restore his account to proper maintenance under the Rules and Regulations of the Chicago Board of Trade amounted to $132,270.00.

Conferences then ensued between Brooks and the Dallas office manager ("Davis") of Merrill Lynch, commencing on May 2, 1973. Davis, in making the margin call, asked if Brooks could meet the margin call, and Brooks advised he could not. Davis, nevertheless, asked him to make an effort to arrange to raise or borrow the money, and Brooks did so, but was unable to make arrangements satisfactory either to Merrill Lynch or himself for such additional funds.

At no time during such conferences did Brooks state he was prepared to meet the margin call or that he was obtaining funds to meet the margin call. In light of the

size of the deficiency, Brooks did not want to order liquidation of the positions and declined to do entreating instead that his positions be maintained until expiration of the contracts or until price movement returned to his favor.

Subsequently, and on or about May 7, 1973, Merrill Lynch prepared, and Brooks, on either May 7 or May 9, 1973, signed a letter acknowledging Brooks' indebtedness in an unspecified amount and promise to pay the actual amount of indebtedness when it was determined. The ostensible purpose of such letter was to ascertain if this would constitute sufficient assurance of payment as to the contract provisions to satisfy the Chicago Board of Trade under its rules and regulations governing extension of credit, with regard to a *continued* extension of credit by Merrill Lynch as broker-lender to Brooks as customer-borrower. There is no evidence that the letter was ever presented to the Chicago Board of Trade, although there is evidence that the legal department of Merrill Lynch determined that such letter would not constitute sufficient assurance of payment. Brooks maintained that the letter was executed in contemplation of a *continued* extension of credit based on his acknowledgment and promise to pay the ultimate indebtedness; Merrill Lynch maintained that such letter was contemplated only to be an assurance that funds were forthcoming and acknowledgement of Brooks' indebtedness (i.e. implied if not express acknowledgment and approval of Merrill Lynch's handling of the account). *See Appendix*

Beginning on May 9, 1973, Merrill Lynch began to buy in contracts to cover the subject short positions, purchasing five (5) contracts on that day, and then buying in nineteen (19) contracts on May 11, 1973 to cover the remaining short positions. At the same time, the debit balance in the Brooks account had grown every day until when liquidated it amounted to $198,262.00.

Historically, after liquidation, the price movement of soybean meal contracts subsequently reversed themselves

sharply in Brooks' favor such that by July 10, 1973, he would have had a credit balance in the amount of $23,658.00, assuming the contracts would still have been open at that time, although following that point, the prices again reversed themselves, and again if the contracts had still been outstanding, would have expired at a loss to Brooks.

This is not a case in which the customer is seeking to recover losses due to claimed mishandling of the account by the broker, but is rather a case in which the broker undisputably mishandled the account and is seeking to obtain reimbursement for its losses from the customer.

It is undisputed that Brooks was first due a margin call on April 12, 1973.

It is further undisputed that no such margin call was made on that day, or on each subsequent consecutive market day up to and including April 30, 1973, the first margin call having been made on May 1, 1973, after market closing, and again in the amount of $132,270.00.

Merrill Lynch was never able to explain why a margin call was not made for the period from April 12, 1973 to after market closing on May 1, 1973, and each of its witnesses professed lack of knowledge as to how the failure occurred, maintaining it was only the fault or responsibility of someone else, with the suggestion that the call had not been made due to some mechanical or human error, otherwise unidentified.

Trial commenced on November 5, 1975, and in the Trial Court's pre-trial order entered that day, Merrill Lynch sought recovery of Brooks for the amount claimed due in the commodity account Brooks maintained with that brokerage firm, $198,262.00, plus interest at the rate of 7½% from May 7, 1973, and Brooks interposed numerous defenses thereto, and counterclaimed for the credit balance that he would have had in his account if Merrill Lynch had closed the account when a margin call was first due, or if Merrill

Lynch had permitted Brooks to select a date the contracts were brought in.

Petitioner's counterclaims, however, were not pursued during trial that immediately followed nor are they before this Court on appeal, as Brooks instead took the position that the parties were *in pari delicto*. It is noted that with regard to one of Brooks' counterclaims, Merrill Lynch took the position that Brooks was "*in pari delicto* with Merrill Lynch", for the reason that he joined Merrill Lynch in violation of its fiduciary duties to him and of the rules and regulations of the Chicago Board of Trade and federal law.

In trial, Merrill Lynch maintained that it had not been negligent in the handling of the Brooks account, and specifically in failing to make a timely margin call, and in carrying the account without proper and adequate maintenance margin; that the commodity account agreement in question was the agreement of the customer and that it as broker was not bound as a party to such agreement; that the rules and regulations of the Chicago Board of Trade generally, and rules and regulations governing extension of credit specifically, are designed for the protection of exchange members (or brokers as lenders) and not for the protection of customers such as Brooks; that it had no duty to make a margin call, timely or otherwise, and that the rules and regulations of the Chicago Board of Trade do not require margin calls but merely authorize the making of margin calls; that even if margin calls were otherwise required, Brooks had waived the necessity of the giving of such a call by the terms of the commodity account agreement; that Brooks had knowledge of the condition of his account at all times and could have ordered liquidation of the account at any time, and had a duty to do so even in the absence of a margin call, if he wanted to minimize his losses; and that by failing to order liquidation, Brooks consented to the broker's handling of the account, including any breach of duty to Brooks as customer or conduct otherwise constituting violation of exchange rules and regulations; and that Brooks would not

have signed the May 7, 1973 letter had he had any complaint as to Merrill Lynch's conduct.

On the other hand, Brooks maintained that the commodity account agreement, if an agreement at all, was an agreement between the parties and binding on Merrill Lynch as well as himself; that the transactions in question were, as expressly provided by the agreement, subject to the rules and regulations of the Chicago Board of Trade and its Clearinghouse; that Merrill Lynch had violated the rules and regulations of the Chicago Board of Trade and its Clearinghouse in failing to make a timely margin call; that Merrill Lynch had breached its duty to him as customer in failing to make a timely margin call; that Merrill Lynch had violated the rules and regulations of the Chicago Board of Trade and its Clearinghouse in carrying the account without proper and adequate maintenance margin; that Merrill Lynch violated the rules and regulations of the Chicago Board of Trade after being told by Brooks that he did not have the funds to meet the amount of the margin call when it was made and told by Brooks that such funds would not be forthcoming; that the purpose of a margin call is to require the customer to make an election to place additional funds or order liquidation of the account, and that, in the absence of such an election by the customer, the broker has the duty and obligation to close the account; that Merrill Lynch willfully breached these various duties; that Merrill Lynch willfully violated the rules and regulations of the Chicago Board of Trade; that Merrill Lynch had contemporaneous knowledge of both the condition of the account and of the violations of the rules and regulations of the commodity exchange; that he had neither expressly waived nor consented to the violations of exchange rules and regulations or compliance with the commodity account agreement; that Merrill Lynch was negligent in the handling of his account, and more specifically negligent in failing to give a timely margin call, and negligent in carrying the account without proper and adequate maintenance margin in the absence of a margin call; that if Merrill Lynch was

correct that it had no duty or requirement to give a margin call and could liquidate the account at its discretion without the giving of such a margin call, then that Merrill Lynch had failed to mitigate losses to the account by prompt liquidation of the positions; that the amount sought by Merrill Lynch as damages represented losses directly attributable to handling of the account by Merrill Lynch and were proximately caused by Merrill Lynch; and that the purpose of the May 7, 1973 letter prepared by Merrill Lynch and signed by Brooks was in contemplation of seeking authority from the Chicago Board of Trade for a continued extension of credit, in light of the manner in which the account had been handled; and that the May 7, 1973 letter was not intended by Brooks to endorse or ratify the prior conduct of Merrill Lynch.

The testimony at trial substantiated the foregoing factual circumstances preceding litigation, and were essentially undisputed except with regard to the contentions concerning the May 7, 1973 letter, as stemming out of the reference to the statement "Per our conversation in your office on May 2, 1973, I agree . . .".

Both parties offered testimony of witnesses as "experts" familiar with the rules and regulations of the Chicago Board of Trade, and the customs and usages on such exchange.

Merrill Lynch's witness, John W. Clagett, testified that the rules and regulations of the Chicago Board of Trade do not specify any given period of time in which margin calls must be made, nor do they specify any given period of time in which undermargined accounts must either be liquidated or brought back to proper margin. Clagett said that a broker having knowledge of the undermargined condition of an account should bring it to the customer's attention but would be under no obligation to do so if the broker had reason to believe that the customer already had full knowledge of the account's condition. Posed with a hypothetical entailing facts similar to those here in issue,

Clagett said, in his opinion, the hypothetical broker would not have violated any rule or regulation of the Chicago Board of Trade or its Clearinghouse. On cross-examination, Clagett testified that the purpose of exchange rules governing margin were "to give security to the brokerage firm" and declined to acknowledge that there was a broader purpose "from the standpoint of the country and the public at large to prevent the overuse of credit and speculation on commodities exchanges." When asked what would occur if brokers handled all their accounts in the manner posed in the hypothetical, Clagett said he did not think such handling would have an "appreciable effect" on the commodities markets themselves.[a]

Robert C. Thinnes, a witness called by Brooks, testified that Chicago Board of Trade requires its members to comply with exchange rules and regulations, and specifically to comply with the provisions of Rule 210, Regulation 1822, and Regulation 1822-A. Thinnes said that the *only* factors that determine the issuance of a margin call are price movements and the activity in the market *on a daily basis.* On cross-examination, although declining to specify a given period of time in which the broker must act to comply with margin rules and regulations, when posed with a hypothetical similar to the facts herein, Thinnes stated that such circumstances "would contravene the purposes of the rules and regulations of the Chicago Board of Trade." Thinnes acknowledged that a delay in compliance "possibly would be beneficial" to the customer in some instances, but in other instances, such a delay would not benefit the customer. On further cross, Thinnes testified that a customer's trading history and financial ability have no bearing on when a margin call should be made.[b]

[a] Clagett is President of the Futures Industry Association, a trade association composed of the principal brokerage firms dealing in commodities. A former employee of the Chicago Board of Trade, in 1955 he established an Office of Investigation and Audits for the exchange and ran it until his departure in 1959.

[b] Thinnes was the then-present Administrator of the Office of Investigations and Audits of the Chicago Board of Trade.

Other witnesses called by Brooks testified that Merrill Lynch's conduct was unreasonable, and in violation of exchange rules and regulations or not in accordance with industry customs and practices.[c]

The case was tried before a jury and the case was submitted to the jury by Trial Court employing special interrogatories with a general charge under F.R.C.P. 49(a).

In this connection, the Trial Court refused to submit requested issues inquiring as to whether Merrill Lynch had violated the rules and regulations of the Chicago Board of Trade governing maintenance margin requirements and maintenance margin calls, and refused to submit requested issues as to whether Merrill Lynch by its conduct had breached the commodity account agreement with Brooks. The Trial Court also refused to submit requested issues inquiring as to whether Merrill Lynch had breached the fiduciary duty of broker to customer, or whether Merrill Lynch engaged in such conduct or various aspects thereof willfully, and whether Merrill Lynch's failure to give Brooks a margin call prior to May 2, 1973 was a proximate cause of the claimed losses.

The Trial Court did not submit any issues inquiring as to the contemporaneous knowledge of Merrill Lynch with regard to the condition of the Brooks account, and that a margin call had not been given and that the account was being carried. At the same time, the Trial Court did not submit any issues inquiring as to Brooks' knowledge, and, more importantly, it did not submit any issues inquiring as to the intent of the parties, express or implied, generally or with regard to the May 7, 1973 letter, excepting only the "consent" issue referred to hereinbelow.

[c] Mr. Sol Jacobs and Mr. Robert Anspacher, both local commodity brokers, whose employer firms are members of the Chicago Board of Trade.

The Trial Court's charge and the jury's answers to the questions put to it may be summarized as follows:

1. Merrill Lynch was negligent in maintaining Brooks' account in an undermargined condition.

2. Such negligence of Merrill Lynch in maintaining Brooks' account in an undermargined condition was a proximate cause of the losses in Brooks' account.

3. Merrill Lynch should have, in the exercise of ordinary care, stopped its maintenance of Brooks' account in an undermargined condition on April 16, 1973.

4. Merrill Lynch was negligent in failing to give Brooks a margin call at a time prior to May 2, 1973.

5. Brooks because of the margin call would not have liquidated his account at any time prior to May 2, 1973.

6. No answer required.

7. Brooks consented to Merrill Lynch's failure to make a margin call prior to May 2, 1973 and to liquidate his account prior to May 9 and 11, 1973.

The last issue noted was responded to by the jury under the following instruction by the Court:

> "You are instructed that a person 'consents to' an omission of another when, by *his neglect, silence, or inaction,* he fails to complain with knowledge of the existence of a right to complain, for a period of time in excess of the time within which a person or (sic) ordinary prudence under the same or similar circumstances would have complained." (Emphasis added)

After return of the jury verdict, both Brooks and Merrill Lynch filed motions for judgment. Merrill Lynch contended that the consent finding by the jury barred Brooks' defenses and counterclaims "whether such defenses and counterclaims are predicated on theories of breach of contract, negligence, breach of fiduciary duty, or violation of rules or statutes."

Subsequently and on December 11, 1975, the Court entered judgment in favor of Merrill Lynch, stating its opinion based on both the jury findings and other conclusions found by the Court as a matter of law. The judgment initially provided for recovery in full by Merrill Lynch of the debit in the account in the amount of $198,262.00, and further provided for interest from the date of judgment. Merrill Lynch moved to amend judgment to include prejudgment interest and a final form of amended judgment was entered by the Trial Court on January 19, 1976, providing that Merrill Lynch have interest at the rate of 7½% per annum from May 11, 1973.

Brooks filed various motions, prior to appealing, for new trial, to set aside the judgment and for reconsideration of the motion to set aside judgment, the last of which was overruled on February 4, 1976. The judgment of the District Court is set forth in Appendix B hereto.

The Circuit Court affirmed the Trial Court's decision, holding that this case involving violations of the rules and regulations of the Chicago Board of Trade is distinguishable from prior decisions involving exchange rules and regulations in securities transactions, because the latter, promulgated under the supervision of the Securities and Exchange Commission "have the force and effect of law" and then, after commending the Trial Court on its employment of the special verdict device, declining to afford relief "to a knowledgeable investor whose only complaint is that the broker, to investor's knowledge, was extravagant in the credit extended." The *per curiam* opinion is set forth in Appendix A hereto.

Accordingly, the result in the Courts below mandated the filing of this Petition requesting that a Writ of Certiorari be issued for the reasons afforded hereinafter.

HOW A FEDERAL QUESTION IS PRESENTED

The underlying transactions on which Merrill Lynch based its suit against Brooks occurred on the Chicago Board of Trade, a commodities exchange regulated under the Commodity Exchange Act, 7 U.S.C. § 1 et seq. Although that act has been superseded or supplanted by the Commodity Futures Trading Act of 1974, the specific provisions involved [§ § 5, 6a(1), 6b(C) and 7a(8)] are substantially similar, if not identical, as they appear in both the present and former statute, and the interpretation of those provisions presented herein would or should be identical.

Interpretation of those provisions, and certain rules and regulations of the Chicago Board of Trade promulgated under the Act, and the supervision of the Commodity Exchange Commission, must be applied to the conduct of a broker-member of the Chicago Board of Trade regulated by the Act and presumably by rules and regulations of exchanges promulgated thereunder.

The opinion of the Circuit Court below, holding that rules and regulations of commodities exchanges promulgated under the Act and the supervision of the Commodity Exchange Commission, and relating to extension of credit in the market, do not have the force and effect of law, would appear to be in direct conflict with the opinions of other Circuits holding that said rules and regulations so promulgated do have the force and effect of law. Specifically, the holding of the Circuit Court below is in direct conflict with those of the Seventh Circuit in *Daniel* v. *Board of Trade of the City of Chicago,* 164 F.2d 815, 118-19 (7 Cir. 1947), and the related case of *Cargill, Inc.* v. *Board of Trade of City of Chicago,* 164 F. 2d 820, 823 (7 Cir. 1947), cert. denied 333 U.S. 880, 68 S. Ct. 912, reh. denied, 334 U.S. 835, 68 S. Ct. 1344, and its more recent decision in *Case & Co., Inc.,* v. *Board of Trade of City of Chicago,* 523 F. 2d 355 358 (7 Cir. 1975) as well as the decision of the Eighth Circuit in *Cargill, Inc.* v. *Hardin,* 452 F. 2d 1154, 1156 (8 Cir. 1971), cert. denied, 406 U.S. 932, 92 S. Ct. 1970.

In light of the prior observation by this Honorable Court in *Ricci* v. *Chicago Mercantile Exchange,* 409 U.S. 289, 293-294, 93 S. Ct. 573, 576 (1973), that commodities exchanges have the *express* statutory duty to enforce all rules and regulations relating to trading requirements (not otherwise disapproved by the Secretary of Agriculture), it is both necessary and desirable that this conflict be resolved.

This important question of federal law and the related question of the means and degree of affirmative action, if any, an investor must take to invoke the protection of the Act as a defense to an action brought by the violator have not been, but should be decided by the Supreme Court.

REASONS FOR GRANTING THE WRIT

This action was an action brought by Merrill Lynch as broker against one of its customers, E. B. Brooks, Jr. to recover an amount which Merrill Lynch claimed constituted a deficiency in Brooks' margin commodity account as due and owing under a commodity account agreement.

The transactions with regard to which the claimed deficiencies resulted were short positions in twenty-four (24) soybean meal futures contracts, and the transactions occurred on the Chicago Board of Trade which is a federally-licensed commodity exchange governed by the provisions of the Commodity Exchange Act, 7 USC § 1, et seq.

In affirming the Trial Court's opinion, the Court of Appeals held:

> "In Investor's brief and during oral argument, this court's attention was directed to two Securities Exchange Act of 1934 opinions, Gordon v. DuPont Glore Forgan, Incorporated, 5 Cir. 1973, 487 F.2d 1260, 1262; and Goldenberg v. Bache & Company, 5 Cir., 1959, 270 F.2d 675, 681, where we declined to allow recovery by a stockbroker from an investor for the amount of the deficiency in his margin account. We believe that regulations promulgated by the Securities and Ex-

change Commission which have the force and effect of law pertaining to securities sufficiently differentiate those cases from this commodities case in which the futures market of short positions serves economically quite a different function in providing hedges to many facets of the commodity world. As such, they are inapplicable and are of no aid to a knowledgeable investor whose only complaint is that the broker, to investor's knowledge, was extravagant in the credit extended."

Since the Securities and Exchange Commission itself has authored no regulations governing the handling of margin accounts, the Court of Appeals is presumably referring to exchange rules and regulations governing extension of credit by members enacted pursuant to the self-enforcement provisions of the Securities Exchange Act of 1934 and under the general supervision of the SEC.[1]

Assuming this to be the case, the Court of Appeals has in effect held that exchange rules and regulations involving margin transactions in securities under the 1934 Act have the force and effect of law while exchange rules and regulations under the Commodity Exchange Act do not have the force and effect of law.

It is noted that there is some question as to whether or not the Court of Appeals even considered the Commodity Exchange Act in deciding its opinion, since no reference whatsoever is made to the Act nor is any reference made to the decisions of this Honorable Court regarding the Act or to other Courts of Appeals' decisions concerning the Act.

As was observed by this Court in *Ricci* v. *Chicago Mercantile Exchange*, 409 U.S. 293, 93 S. Ct. 573 (1973), Congress passed the "Grain Futures Act", 42 Stat. 998

[1] It is possible the Court was referring to Regulation T promulgated by the Federal Reserve Board although such a reference is unlikely not only in view of the specific mention of the SEC, but also for reason that the reference to regulations is in the plurality.

(changed to the present Act in 1936, 49 Stat. 1491), "[r]ecognizing the public interest involved in '[t]ransactions in commodity (sic) involving the sale thereof for future delivery [futures]' and the burden upon Interstate Commerce imposed by 'sudden or unreasonable fluctuations in . . . prices.'" 93 S. Ct. at 575, 409 U.S. at 291.[2]

As in the case of the Securities Exchange Act of 1934, it is clear the Congress intended to promote the self-regulatory functions of commodities exchanges as "contract markets". See 7 U.S.C. § 7a (8).[3]

The Chicago Board of Trade is a contract market as defined by the Act, and so designated, and Merrill Lynch in executing trades in the subject soybean meal contracts and in maintaining short position in such futures, was, or acted as, a member of the contract market maintained and operated by the Exchange.

As a member, Merrill Lynch was bound by the rules and regulations of the Exchange. *Daniel* v. *Board of Trade of the City of Chicago*, 164 F.2d 815, 818-19 (7 Cir. 1947) (no separate writ history); (related case) *Cargill, Inc.* v. *Board of Trade of City of Chicago*, 164 F.2d 820, 823 (7 Cir. 1947), cert. denied 333 U.S. 880, 68 S. Ct. 912, reh. denied 334 U.S. 835, 68 S. Ct. 1344 (1948).

Indeed, even if Merrill Lynch was not itself a member of the Exchange, the rules and regulations of the Exchange are binding on Merrill Lynch so long as it acted through a member in its transactions. *Cargill, Inc.* v. *Board of Trade of City of Chicago*, 164 F. 2d at 823. Moreover, the Com-

[2] The Court found federal regulation of futures trading to be constitutional under the Commerce Clause, Art. I § 8 cl. 3, of the Constitution in *Board of Trade of the City of Chicago* v. *Olsen*, 262 U.S. 1, 43 S. Ct. 470 (1923).

[3] As amended February 19, 1968, Section 7a(8) provides: "[Each contract market shall] . . . enforce all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board thereof or any committee, which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements and which have not been disapproved by the Secretary of Agriculture pursuant to paragraph (7) of section 12a of this title. . . ."

modity Account Agreement between Brooks and Merrill Lynch expressly provided that the subject transactions would be subject to the rules and regulations of the Chicago Board of Trade.[4]

Thus, it would seem that with such stipulation as part of the agreement or contract upon which Merrill Lynch based its recovery, the Chicago Board of Trade rules and regulations would constitute the law of the case even if they were otherwise not deemed to have the force and effect of law under the self-regulatory provisions of the Act.

It is respectfully submitted that the opinions of the Lower Courts in the instant case conflict with the prior decisions of the Seventh Circuit noted above and may well be at war with the decisions of this Court and in any event should not have repealed the Commodity Exchange Act by implication in entirely omitting any reference to the Act or these and other prior decisions.[5]

Alternatively, as a case of first impression, this Honorable Court should decide whether it is in the public interest that exchange rules and regulations promulgated under the supervision of the Securities and Exchange Commission should be given the dignity of law but that exchange rules and regulations promulgated under authority of the Commodity Exchange Commission (or its successor, the Commodity Futures Trading Commission) should not be

[4] The first paragraph of the agreement provides: Any and all transactions shall be subject to the constitution, rules, regulations, customs and usages of the exchange or market (and its clearing-house, if any), where executed.

[5] This Court has implicitly recognized the self-regulatory function of the commodity exchanges and the rules and regulations of such exchanges in both *Ricci* v. *Chicago Mercantile Exchange, supra,* and *Chicago Mercantile Exchange* v. *Deaktor,* 414 U.S. 113, 94 S. Ct. 466. (1973) It is noted both these decisions hold that when violations of exchange rules and regulations have been alleged, the dispute should be referred to the Commodity Exchange Commission under the doctrine of primary jurisdiction to ascertain whether a violation has in fact occurred. However, it may be said that both the Lower Courts assumed arguendo that violations of exchange rules and regulations had in fact occurred, holding that such violations did not alter the result below.

accorded such dignity, as expressed or not expressed by Congress, or by the courts in interpreting Congressional intent by means of something more than the blithe statement made by the Court of Appeals below.

Having so distinguished the force and effect of regulations governing commodities transactions from those governing transactions in securities, the Court of Appeals goes on to describe this case as one "in which the futures market of short positions serves economically quite a different function in providing hedges to many facets of the commodity world". While the meaning of this statement is not altogether clear, Petitioner gathers that the Court is saying that "short positions in futures contracts" are not "securities", and that the rationale and reasoning employed in cases involving securities are inoperative as to the facts of this case.

Petitioner has not heretofore contended, and is not now contending, that futures contracts are "securities".[6] By the same token, if futures contracts are not "securities" both the contracts themselves and short positions in those contracts are "different" to some extent. Nevertheless, do such differences justify the abrogation of otherwise well-established principles of law?

Futures contracts are traded on exchanges, as are securities. Both represent a tangible interest in (other) property, both are conducive to active speculation, and at least by speculators, both are traded generally for purposes of short-term capital gain.[7]

[6] e.g. See Page 40 of Petitioner's initial appellate brief filed herein-below; the lead case so holding is *Sinva, Inc.* v. *Merrill Lynch Pierce Fenner & Smith, Inc.*, 253 F. Supp. 359, 365-367.

[7] Few commodities traders ever actually take delivery of the crop or crops represented by the contracts (e.g. Brooks has taken delivery on only one such contract), and, by the same token, many, if not most securities investors have only a passing interest in capital infusion and the ultimate fortune of the companies in which they invest, as distinguished from appreciable (and rapid) return on such investments (e.g. reference is made to the recent development and phenomenal growth of trading in options, in both securities and commodities alike).

The underlying purpose of both markets is identical in that both were created to facilitate the infusion and formation of capital, in one instance with regard to agricultural crops and other "raw" goods and, in the other instance, to promote the infusion and formation of capital for either making finished products out of those and other natural resources and for distribution of both finished and unfinished goods. In a word, the fundamental purpose of both markets is that of *speculation* and the federal regulatory scheme as to both markets was intended by Congress to permit the speculation essential to these markets, and thus to our society, recognizing at the same time the need to prevent speculative abuse and excess which, if left uncontrolled, might destroy not only the markets themselves, but the segments of our economy serviced by those markets, which in turn would impair the health of the general economy and the public welfare.

No one disputes that this is a case of speculative abuse. What has not been decided is whether the abuse present here is condoned or prohibited under the Act, or exchange rules and regulations promulgated under the Act and supervision of the Commodity Exchange Commission, and if the given abuse is prohibited, on whom the burden of that prohibition must fall.

The instant case entails the rules and regulations of the Chicago Board of Trade, and its Clearinghouse, as well as the customs, usages and practices relating to such contract market pertaining to the handling of margin transactions and customer accounts and more particularly the rules and procedures concerning maintenance margins and maintenance margin calls. The rules and regulations specifically involved are Rule 210 of the Chicago Board of Trade, Regulations 1822 and 1822-a of the Chicago Board of Trade and paragraph "c" of Rule 928 of the Chicago Board of Trade and Clearinghouse.[8]

[8] See Appendix C. At trial, Merrill Lynch was unable to identify Rule 928 or Paragraph "c" thereof as a rule or regulation of either the Chicago Board of Trade or its Clearinghouse, objecting to admission of a copy of said Rule as an exhibit, and said Exhibit was not admitted by the Trial Court. This does not alter the fact that Rule 928 is a Rule of the CBOT Clearinghouse, and therefore part of the law of the case.

The relevance of these rules and regulations to the transaction in question was recognized by the Court of Appeals as follows:

> "... As the price of soybean meal increased ... Rule 210 and Regulation 1822, ¶ 14 of Chicago Board of Trade necessitated that Investor increase the balance in his margin account. This increase is called 'maintenance margin' ... Merrill Lynch did not notify the Investor on April 12, 1973, the day his margin account became insufficient or 'undermargined', and not until May 1, 1973, did it demand that Investor deposit the contractually required 'maintenance margin'. Despite this failure to make timely demand...
>
> "... Merrill Lynch proceeded on May 9, under its Commodity Account Agreement with Investor to cover Investor's twenty-four contracts and liquidated his margin account at an indebtedness of $198,262. This liquidation occurred later than it could have had the demand for maintenance margin been made on April 12. Rule 209 of the Chicago Board of Trade allows reasonable time to meet such a demand which is interpreted to be one hour in usual circumstances." 548 F.2d at 616.

As discussed above, the Court of Appeals held that commodity exchange rules and regulations do not have the force and effect of law, despite prior decisions to the contrary.[9] See *Cargill, Inc.* v. *Hardin*, 452 F.2d 1154, 1156 (8 Cir. 1971), cert. denied, 406 U.S. 932, 92 S. Ct. 1770 (1972) ("Trading in commodities futures is regulated by the Secretary of

[9] In *Ricci* v. *Chicago Mercantile Exchange*, this Honorable Court said: "Contract markets must file with the Secretary their bylaws, rules and regulations, and have *the express statutory duty to enforce all such prescriptions (1) 'which relate to terms and conditions in contracts of sale . . . or relate to other trading requirements, and which have not been disapproved by the Secretary of Agriculture pursuant to his statutory authority,* id § 7a(8) . . ." 409 U.S. at 293-294, 93 S. Ct. at 575-576 (Emphasis added).

Agriculture pursuant to the provisions of the Commodity Exchange Act . . . and must be conducted only on a designated contract market *in accordance with the market rules.*"); *Case & Co., Inc.* v. *Board of Trade of City of Chicago,* 523 F.2d 355, 358 (7 Cir. 1975) ("'rules' adopted by the Board's membership and 'regulations' adopted by its directors govern trading in commodities futures on the exchange and are incorporated into every contract'").[10]

Even if the Fifth Circuit is correct in its holding and correspondingly the Seventh and Eighth Circuits are in error, and commodity exchange rules and regulations do not have the force and effect of law, the Court of Appeals was still confronted with such rules and regulations nevertheless being "the law of the contract". It disposed of this problem by focusing its attention on Brooks' knowledge of the condition of his account, and endorsement of the Trial Court's conclusions regarding "consent" and "ratification", thereby posing and holding that a customer having knowledge of margin violations has an affirmative duty to complain of the violations at the time they are occurring, *not to establish Broker's liability,* but rather to excuse such violations unless the customer has taken affirmative action at the time the violations occur.[11]

Petitioner is not here contending that he should recover either the amount which constituted his initial margin ($24,000.00) nor the funds otherwise in his account, there for the purpose in part of satisfying additional maintenance requirements. Instead, it is the broker, which, having failed to properly maintain the account within the scope of its agency and as a fiduciary, carried the customer in violation of exchange rules and regulations, and further failed to make a timely margin call. The Lower Courts have excused

[10] See also Senate Report No. 947 regarding P.L. 90-258 amending the Act in 1968, 2 U.S. Cong. & Admin. News '68, pps. 1674-1676, 1681.

[11] Cf. *Baker* v. *Edward D. Jones & Co.* C.F.T.C. Docket No. R 76-4 (December 6, 1976), CCH Com. Futures Law Rpts., Current Vol. ¶ 20,241.

broker's conduct and permitted broker to recover an amount as damages stemming directly out of those violations, and broker's negligence, principally for the reason that Brooks was "at all times aware of the condition of his account" such that the giving of the otherwise required margin call was found to be "unnecessary."[12]

The Lower Court findings are due to a fundamental misconception of the nature and purpose of a margin call. While it could be said that a margin call is a means of advising a customer of the condition of his account, a margin call is by nature essentially a demand that additional funds be placed as security for a position, or, absent the placing of such additional funds, that the position be liquidated. The placing of a margin call is intended to compel the customer to make such an election, and failing an election by the customer-borrower within a reasonable time, then enabling *and compelling* the member-lender to liquidate the customer's position. Adherence to the procedure protects the broker's position as both agent and fiduciary, avoiding altogether possible conflict as between lender and borrower. This procedure, established by the rules and regulations of the Chicago Board of Trade, is designed to be self-enforcing and to preclude a controversy such as that presented in the instant case. In the absence of such a procedure, a member-broker might well be placed in the position of having to make the election of acting to protect its own interests, as opposed to continuing to act to protect the interests of its customer in its role as a fiduciary. This, of course, is precisely what occurred in the instant case.

> "The relationship between broker and customer is fiduciary in its nature. The legal incidents of that relationship are well-established in existing law. They are of the same character as those which pertain to agents to whom money or other property is entrusted for purposes of the agency. In the performance of his duties, the broker is held to the same high standard of conduct

[12] Cf. *Gordon* v. *DuPont Glore Forgan Inc.*, 487 S. 2d 1260, 1262 (5 Cir. 1973), cert. denied 417 U.S. 946, 94 S Ct. 3071 (1970).

as the law imposes upon attorneys, administrators, executors, guardians, bankers, public officials, and other persons vested with fiduciary powers. He is required to exercise the utmost fidelity and integrity. He is under a duty to act solely for the benefit of his principal in all matters connected with his agency....

"It is common law rubric that when one is engaged as agent to act on behalf of another he must do just that. He may not bring his own interest into conflict with his principal's. If he does, he must explain in detail what his self-interest in the transactions is in order to give his principal an opportunity to make up his mind whether to employ an agent who is riding two horses. This requirement has nothing to do with good or bad motive. In these circumstances, the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and duty to principal or client...." Loss, *Securities Regulation*, Vol. II, Ch. 7D, page 1216 (1962 ed.).

As observed by Loss, and as held by this Court more than 100 years ago, the law "acts not on the possibility that, in some cases, the sense of that duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty." *Michoud* v. *Girod*, 4 How. 503, 555 (1846).

The Trial Court and the Court of Appeals did not *neglect* to consider Merrill Lynch's conduct in the light of its role as a fiduciary; to the contrary, the Courts below *refused* to consider whether Merrill Lynch was (or was supposed to be) acting as a fiduciary for Brooks in handling his account.[13]

In this connection, it is essential to note here Merrill Lynch's contentions in the Courts below that (1) the terms and provisions of commodity account agreements are binding on customers, but not on Merrill Lynch; (2) that the rules and regulations of the Chicago Board of Trade are designed to protect member-brokers such as Merrill Lynch, not to protect customers such as Brooks; and (3) that margin call procedures generally are designed to protect only brokers, not to protect customers.

Astounding as it may be that the Lower Courts failed to even chide Merrill Lynch for such contentions by way of dicta or passing comment, this omission is dwarfed by the like refusal of both the Trial Court and the Court of Appeals to inquire, or to permit inquiry, as to Merrill Lynch's knowledge of the violations at the time of their occurence. At trial, Merrill Lynch professed lack of knowledge as why the margin call was not made on Brooks when first due, or on each day thereafter until twenty (20) days after a margin call would first have been due, and each of its witnesses professed lack of knowledge of Brooks' account at the same time professing that such failure was a result of mistake, lack of knowledge, inadvertence or someone else's responsibility. In almost the same breath, Merrill Lynch established Brooks' "daily knowledge" of the condition of his account by testimony of its witnesses that Brooks was in its local office "almost daily" discussing the price action as to his positions with its account executive and that he knew the condition of his account "to the penny". The importance of this curious testimony was acknowledged by the Court of Appeals, 548 F.2d at 616

[13] The Trial Court refused to submit Brooks' requested issues inquiring as to whether or not Merrill Lynch had breached its fiduciary duty to Brooks in failing to make a timely margin call, in carrying his account in an undermargined condition, in failing to make a timely liquidation of his account, in failing to otherwise advise him as to when and under what circumstances a margin call would be made, or in failing to otherwise advise him when and under what circumstances the account would be liquidated. Having refused such requested issues, the Trial Court then failed to even mention the term "fiduciary" in its opinion or otherwise discuss the duties of broker to customer despite Petitioner's repeated contentions before, during and following trial that a fiduciary relationship should and did exist and that Merrill Lynch had breached its fiduciary duty; the Court of Appeals entirely disregarded this complained error first by silence, and secondly by specifically endorsing and approving the special verdict device and issues submitted by the Trial Court to the jury.

("In fact, Investor went to Merrill Lynch's local office daily to check on his commodities transactions.").

The clear implication in the opinions below is that Brooks had superior knowledge of the condition of his account (. . . "Brooks was a sophisticated and knowledgeable investor who carefully followed his account with greater acumen than that demonstrated by his broker", 404 F. Supp. at 907), and both Courts apparently felt that an inquiry into Merrill Lynch's knowledge regarding the condition of the Brooks account would be of no significance and irrelevant.[14]

Petitioner respectfully submits that it was fundamental error for the Courts below to consider only his knowledge of the transactions and the violations in connection therewith, wholly failing to consider both broker's contemporaneous knowledge of both the condition of his account and the accompanying violations of exchange rules and regulations.

Alternatively, Petitioner respectfully submits that Merrill Lynch's knowledge was established by its own testimony in the underlying record, in turn establishing that Merrill Lynch knowingly failed to make a timely margin call and knowingly carried Brooks' short position without proper and adequate margin in knowing violation of the rules and regulations of the Chicago Board of Trade and its Clearinghouse and the customs and practices thereof.

The circumstances then confronting this Court would not be those of a knowing, sophisticated investor dealing with an unknowing and unsuspecting broker. To the contrary, the circumstances then presented would be those of a broker

[14] The Trial Court refused to submit Brooks' requested issues inquiring as to whether Merrill Lynch had willfully failed to give Brooks a margin and maintenance call when due, willfully carried Brooks' without proper and adequate margin, or willfully failed to comply with the rules, regulations, customs and usages of the Chicago Board of Trade. The Court of Appeals entirely disregarded the complained error, not only by means of silence in omitting to treat the claimed error in its opinion, but further by specifically approving and endorsing the special verdict device *and* the issues as submitted by the Trial Court. Cf. *Goodman* v. *Benson*, 286 F. 2d 896, 900 (7 Cir. 1961).

which independently, for whatever reasons of its own,[15] *knowingly extended prohibited credit to the customer*, or circumstances in which broker and customer tacitly (or expressly) agreed to disregard those same exchange rules and regulations governing the extension of credit.[16]

Had Brooks and Merrill Lynch expressly agreed that Merrill Lynch would extend credit initially to Brooks, or thereafter continue to extend credit to Brooks, without regard to either initial or maintenance margin requirements set forth by the rules and regulations of the Chicago Board of Trade, this Honorable Court would scarcely countenance Brooks' raising such violations as a defense; however, at the same time, under this circumstances, or under the circumstance that Merrill Lynch unilaterally and knowingly violated such rules and regulations, would this Honorable Court (or should any other Federal Court) permit or enable Merrill Lynch to obtain the relief it has obtained in the Courts below. Again, the question must necessarily be posed in the hypothetical since the requested inquiry as to the knowledge of Merrill Lynch was not permitted, and the requested findings not made or considered.

[15] It is noted historically that Brooks had paid Merrill Lynch approximately $85,000.00 in commissions while realizing a net return of only approximately $15,000.00, in his commodity trading activities. Moreover, in connection with another series of transactions completed, just prior to the date Brooks took out the short positions in question, Brooks had had difficulty in obtaining funds to cover his position, and had advised that the funds on account were "all he had" to finance the subject transactions. (Merrill Lynch attempted to minimize this testimony by contending that Brooks made similar remarks on earlier occasions).

[16] Neither Merrill Lynch nor Brooks contended or even suggested that there was either express or tacit agreement regarding carrying of the account or withholding of timely margin call for the twenty (20) days preceding the date the margin call was initially made. Indeed, Brooks testified that he had asked the Merrill Lynch representative why he was not receiving a margin call, such testimony not being refuted by Merrill Lynch. It is not here suggested that Petitioner either expressly agreed with Merrill Lynch to disregard exchange rules and regulations or, of course, that Brooks actively sought to induce such violations at any time prior to the May 1, 1973 margin call.

The Trial Court, finding that the law of the State of New York governed the contract, further found that "[u]nder New York law every violation by a broker of a statutory command or prohibition or of a rule of an exchange does not result in the inability of a broker to enforce civil liability on a customer."[17]

The New York cases cited as authority for such proposition are *Irving Weis and Co.* v. *Offenberger,* 220 NYS 2d 1001, and *Nichols & Co.* v. *Columbus Credit Corp.,* 204 Misc. 848, 126 NYS 2d. 715, aff'd. 284 App. Div. 870, 134 NYS 2d. 590. Unfortunately, the Trial Court's conclusion about applicable New York law does not embrace the entire state of the law in New York; for example, in *Nichols, supra,* the principal case relied on by Merrill Lynch in the Courts below, the state court said:

> "It has come to be recognized in recent years that margins in speculative accounts, although chiefly for the broker's protection as security for credit risks involved in acting for its customer, have a relation to public interest because requirements of large margins are at least believed to have some effect in checking speculation of a nature and extent deemed contrary to public interest and a broker who persistently and intentionally is too indulgent with a customer in respect of margin doubtless will find himself in trouble with public authorities charged with the duty of enforcing such statute and regulation or with the governing body of his exchange charged with the duty of enforcing the rules of such exchange... The customer is the one who is speculating not the broker... I do not say there cannot possibly be circumstances under which a broker could be held liable for damages actually shown to have resulted to the customer from the broker's failure to require margin, I merely say that mere failure to comply with

[17] Petitioner finds it somewhat contradictory that New York law was deemed to govern the contract simply because the account agreement so provided while at the same time the Trial Court apparently felt free to disregard the express language noted in the agreement requiring adherence to exchange and clearinghouse rules and regulations.

> the rule in question does not impose upon the broker ***absolute*** **liability for subsequent market fluctuations."**[18]

Indeed, it emerges that the actual rule in New York is that violation of exchange rules and regulations standing alone does not establish liability, and that the additional requirement is that the customer be able to show that he has been damaged by such violation, the latter being a well-established principle of law applicable to almost any complaint relating to both tortious acts and breach of fiduciary or contractual duties.[19]

The New York "rule" has been so clarified by comment in later cases; for example, in *Grandbery, Morace & Co.* v. *E. L. Bruce Co.,* 308 NYS 2d. 970 (Sup. Ct. 1969), the state court observed:

> "However, proof of the mere violation of the statutes or rules does *not necessarily* import liability or imply a defense [citing *Nichols* and other cases]. *As these cases hold, causally-related damages must be shown.*" (Emphasis added).

Moreover, New York courts have consistently held that federal law may serve as a defense to a claim based on New York law. See *Standard Bred Owners Ass'n., Inc.* v. *Yonkers Raceway, Inc.* 35 Misc. 2d 1081, 232 NYS 2d 346 (Sup. Ct. 1962) aff'd. mem. 20 A.D., 2d 628, 245 N.Y.S. 2d 956 (App. Div. 1963; *Remington Rand, Inc.* v. *International*

[18] To the same effect, see *Weis* v. *Offenberger, supra,* at page 1003.

These New York cases generally involve provisions regarding *overextension* of credit; here, Rule 210 and ¶ 7 of Regulation 1822-A prohibit *any* extension of credit although an extension of credit has not occurred, nor is the customer relieved of liability "... *if the member in the exercise of ordinary care has been unable to close the account without incurring such deficit or undermargined condition.*" [¶ 14 of Regulation 1822-A]

[19] Most, if not all of the New York cases relied on by Merrill Lynch in the Courts below related to the broker's failure to obtain the required initial margin from customers in securities transactions. These cases do not involve the failure to make a timely margin call. It is interesting to note as well that the Trial Court relied principally on these decisions in securities cases while the Court of Appeals noted that margins in commodities transactions serve quite a different function.

Bus. Mach. Corp., 167 Misc. 108, 3 N.Y.S. 2d 515 (Sup. Ct. 1937) and cases cited therein at 3 N.Y.S. 3d 522.

This rule has been held by the New York courts to apply in margin cases; for instance, in *E. F. Hutton & Co.* v. *Weinberg,* the state court indicated that the rule would be imposed where the broker "induced" the customer to engage in trades with the broker, or ". . . aided and abetted in violating the margin requirements relating to [the] transactions . . . .", or where the customer could show ". . . causal or proximate relationship between the alleged violation of the law and his claimed damages." . . . . (Sup. Ct. 1964), 151 N.Y.L.J. No. 40 page 16; CCH Fed. Sec. L.Rep ¶91,332, p. 94, 407 ('61-'64 Transfer Binder).[20]

At the same time, the Courts below studiously disregarded the prior decisions of brethren Federal Courts most likely to be familiar with New York state law and the reconciliation of New York law with pertinent Federal Law, i.e., the Second Circuit and the District Courts of New York.[21]

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[20] Cf. *Meyer* v. *Shields & Co.*, 25 A.D. 2d 126 (Sup. Ct., App. Div. First Dept. 1966), in which the Appellate Division reversed the Supreme Court's dismissal of a customer's action based on the finding that the customer had participated in the margin violation, observing "[i]t is now well established that where one violates a legislative enactment by doing a prohibited act and thereby causes injury to another, the latter has a civil right of action if one of the purposes of the statute was to protect interests similar to his own. 2 Restatement, Torts § 286 (1934)." (This case involves violation of Regulation T and such a customer would presumably be unable to establish liability now in light of Regulation X).

[21] e.g. *Seligson* v. *New York Produce Exchange*, 378 F. Supp. 1076 (S.D.N.Y. 1974) holding that "[t]he regulatory scheme which had been established by this chapter [the Commodity Exchange Act] is designed to protect investors and to police those who work in the marketplace . . . the prime purpose of the Act [is to insure] fair practice and honest dealing in commodity exchanges and provide a measure of control over those forms of speculative activity which demoralize the markets to the injury of producers and consumers and the exchanges themselves . . ." 378 F. Supp. at 1086.

Perhaps the most controversial of these decisions reconciling applicable New York law with Federal Law in broker-customer suits concerning margin violations is *Pearlstein* v. *Scudder & German* 429 F. 2d 1136 (2 Cir. 1970), cert. denied, 401 U.S. 1013, 91 S. Ct. 1250 (1971), (second appeal) 527 F. 2d 1141 (2 Cir. 1975), referred to as *Pearlstein I* and *II,* respectively. *Pearlstein I* **held that customer could** establish liability against broker for violation of federal margin requirements notwithstanding customer's contemporaneous knowledge of violation and notwithstanding prior stipulations of settlement and confession of judgment alleged by the broker to constitute consent, waiver, ratification and estoppel. The case involves securities transactions, and violations of regulation T and Section 7(c) of the Securities Exchange Act of 1934.[22]

Subsequent to *Pearlstein I,* Congress added Section 7(f) to the 1934 Act and the Federal Reserve Board promulgated Regulation X, leading the Court to question the "viability of the rationale of our prior holding", as noted in *Pearlstein II,* 527 F.2d 1141, 1145, footnote 3.[23]

Pearlstein I and *II* are nevertheless pertinent to this case by reason of the conclusions that (1) "[u]nder New York law, a party to a contract who renders his performance illegal by his own fault appears to be liable for the breach . . .";[24] (a) that New York courts have held that "federal law may serve as a defense to a state claim but may not be utilized as the basis for an affirmative recovery."[25]; (3) that *Irving Weis & Co.* v. *Offenberger, supra,* and similar New York cases deal only "with the broker's right to sue for the

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[22] Regulation T of the Federal Reserve System, 12 C.F.R. § 220.4 (c) (2); Section 7(c) of the 1934 Act, **15 U.S.C. § 78g(c)**

[23] 15 U.S.C. § 78g(f); regulation X, 12 C.F.R. § 224 (1975). These provisions make it unlawful to obtain credit in violation of the margin requirements.

[24] *Dolman* v. *United States Trust Co.*, 206 Misc. 929, 134 N.Y.S. 2d 508, 511, aff'd, 1 A.D. 2d 809, 148 N.Y.S. 2d 809, rev'd on other grounds, 2 N.Y. 2d 110, 157 N.Y.S. 2d 537, 138 N.E. 2d 784; Restatement of Contracts §§ 457, 458.

[25] 429 F 2d at 1144.

original contract price . . ."[26] and (4) that under New York law "a plaintiff who fails to avoid the consequences of a tort is disabled from recovering those damages which he could have reasonably avoided."[27]

It is noted that the Second Circuit rejected application of the last-stated principle, observing:

> "However, we fail to see how the principle is applicable here and how we can charge Pearlstein with any obligation to divine the course of the market at any particular time. Armed with hindsight, we can now characterize the market as obviously declining, but how can we charge Pearlstein with this prescience." *Ibid.*

It is important to note here how the circumstances presented in *Pearlstein I* and *II* are dissimilar from those in the instant case; as succintly stated by Judge Friendly in his dissent, Pearlstein "bought the bonds against Defendant's advice, refused to sell them on its urging, remained silent when Defendant was pressing for payment, and settled his liability after having had legal advice. *Equity would leave the loss where it lies*" 429 F.2d at 11.49. In the instant case, Brooks placed with Merrill Lynch not only sufficient funds to cover the initial margin requirements, but left on deposit with Merrill Lynch additional funds to cover possible maintenance margin requirements, advising that the totality of such funds was "all he had". Here, it was Merrill Lynch which failed to make a timely maintenance margin call (which again would have required a decision by Brooks or failing this, placed Merrill Lynch in a position to liquidate the account as provided by the Rules); here, it was Merrill Lynch which after finally having made the margin call some twenty (20) days late, in a highly volatile market, and upon being advised by the customer that he could not obtain the funds to meet the margin.

[26] 429 F 2d at 1141, footnote 9, and 429 F. 2d at 1144, footnote 12.

[27] 527 F 2d at 1145, citing *McClelland* v. *Climax Hosiery Mills*, 252 N.Y. 347, 358-59, 169 NE 605, 609-10 (1930), 28 Yale Law Journal 827 (1919), and C. McCormick Damages 128 (1935).

nevertheless requested that he make further efforts to obtain such funds; and here, it was Merrill Lynch which prepared a letter for Brooks' signature as a basis for continued extension of credit. Here, the brokerage firm has sought (and succeeded below in) shifting the entire loss to Brooks by showing only that Brooks, knowing the "condition" of his account could have minimized "*his*" losses by ordering liquidation.

The basis for shifting the loss from Merrill Lynch to Brooks is predicated on the consent and ratification findings made by the Trial Court and impliedly, if not expressly, approved by the Court of Appeals. The Courts below found that Brooks "consented" to the negligence of Merrill Lynch when . . . "by his *neglect,* silence, or inaction, he [failed] to complain with knowledge of the existence of a right to complain, for a period of time in excess of the time within which a person or (sic) *ordinary prudence* under the same or similar circumstances would have complained."[28]

This "consent" finding is not only invalid for the reason that the jury could simply have concluded that Brooks was negligent and yet such finding has been interposed as a bar to Brooks complaining as defendant of the negligence of the plaintiff, but further for the reason that finding of "consent" in this context places on customers an affirmative duty to enforce, greater than the duty imposed on exchange members to comply with, rules and regulations of the Chicago Board of Trade.[29]

However appropriate such a finding might be in an action brought by a customer for funds previously paid by the customer to the broker, such a finding is altogether inappropri-

[28] The jury made a finding that Brooks had consented to Merrill Lynch's failure to make a margin call prior to May 2, 1973 and to liquidate his account prior to May 9 and 11, 1973 based on the Trial Court's express instruction containing the quoted language.

[29] While the rules and regulations of the Chicago Board of Trade prohibit extension of credit, there is apparently no provision equivalent to Section 7(f) of the Securities Exchange Act of 1934 or Regulation X of the Federal Reserve Board. This suggests that the primary, if not exclusive, responsibility for compliance with such rules and regulations is placed on member-brokers such as Merrill Lynch.

ate when, as here, it excuses a broker of its otherwise unexplained violations of exchange rules and regulations governing the transactions in question and breaches of its duty to its customer, and simultaneously enables broker to fail to account for its failure to mitigate the losses and damages it seeks to impose upon the customer.

The Trial Court, perhaps recognizing the otherwise fatal defect in the consent finding made by the jury[30] combined such finding with *its* finding that Brooks "acting with full knowledge" signed the Merrill Lynch letter of May 7, 1973, and that such action constituted *ratification* as a matter of law by Brooks of Merrill Lynch's conduct in its entirety. This ratification "finding" by the Trial Court as impliedly, if not expressly, approved by the Court of Appeals cannot stand for the following reasons:

(1) The only finding made by the trier of fact as to Brooks' knowledge was that he had knowledge of the right to complain, and (2) such knowledge combined with general knowledge of the condition of the account and of maintenance margin requirements cannot be equated into knowledge of all material facts as a matter of law, in the absence of an express jury finding, especially when the writing which purports to constitute the act of ratification contains no language manifesting such express intent, and (3) the letter was an instrument executed altogether for another stated purpose and (4) was obtained under circumstances suggesting duress, if not coercion.[31]

[30] Petitioner below at all times objected to the propriety of the consent issue submitted in that an affirmative finding by the jury would only establish that Petitioner was negligent and that his negligence did not serve to excuse the violations or bar him from asserting the negligence of Merrill Lynch as a defense to its recovery.

[31] The record shows that Brooks signed the Merrill Lynch letter of May 7, 1973 with the understanding that the letter was to be presented to the Chicago Board of Trade. While Merrill Lynch acknowledges that the letter was prepared and signed for this purpose, Merrill Lynch never presented the letter to the Chicago Board of Trade and instead proceeded to liquidate Brooks' positions. Merrill Lynch, in failing to use the letter for its understood purpose, breached its fiduciary duty to Brooks, but the Courts below refused to consider or even acknowledge that duty.

Merrill Lynch breached its fiduciary duty in failing to disclose to Brooks all material facts as to why it was securing Brooks' signature on the letter it prepared.[32] In the absence of such disclosure, Merrill Lynch also invalidated the very act of ratification it was seeking to secure. See *Horner* v. *Ferron,* 362 F2d 224 (9 Cir 1966). cert. denied 385 U.S. 958, 87 S. Ct 397. Moreover, said failure to disclose (if not overt misrepresentation concerning) the true purpose of the letter is almost certainly a violation of the Commodity Exchange Act. See 7 USC 6b (C). Cf. *Bibb* v. *Allen* 149 U.S. 481, 13 S. Ct. 950 (1893); *Irwin* v. *Williar,* 110 U.S. 499, 4 S. Ct. 160 (1884).

However outmoded the rationale employed by the Third Circuit in *Pearlstein I* might otherwise be, as noted by the Third Circuit itself in *Pearlstein II,* the court recognized and thoughtfully addressed the dilemma of a customer being confronted with an appreciable financial loss in his account in deciding whether to unequivocally make the loss his own by ordering liquidation or agreeing to an arrangement proposed by the broker to delay, if not preclude, the losses in question:

> "Even apart from the continuing ability of Scudder & German to liquidate the bonds on Plaintiff's account, we think that the stipulations do not bar this suit. Assuming that plaintiff and defendant both believed that it was impossible for defendant to sell the bonds after their delivery to the Bank, the plaintiff's primary

[32] It is curious to say the least that a man who declined to order liquidation of his positions, stating at the same time he did not have sufficient funds to meet a margin call, would voluntarily execute a letter acknowledging his indebtedness with the understanding that his positions were going to be liquidated by Merrill Lynch at the first opportunity to do so. Merrill Lynch interoffice correspondence states that the only reason why the indebtedness was not specified was because the market was "up the limit", preventing liquidation of the positions. Surely, a sophisticated and knowledgeable investor such as Brooks has been characterized hereinbelow would never execute a letter under such circumstances. Yet Merrill Lynch maintained that Brooks did sign the letter of May 7 with full knowledge, not for the purpose of having the jury so find by factual determination, but as found by the court as a matter of law.

motive to answer into the stipulation was undoubtedly the desire to gain enough time to meet his debt, thus avoiding an immediate judgment which might precipitate his bankruptcy or at least cause him serious financial strain. Nevertheless, it was defendant's very failure to sell the bonds on time which produced this financial difficulty on the part of the plaintiff, for if the Lionel bonds, at least, had been sold seven (7) days after their purchase date, they would have yielded a gain rather than a loss. Thus if plaintiff did waive any of his rights, he appears to have done so under financial pressures directly resulting from defendant's violation of Regulation T... Here it is difficult to say that Pearlstein's waiver was knowing, *given the apparent lack of any inducement to give up his rights other than financial pressure.* But if the waiver were knowing, it would not secure some desirable end, such as aribtration, easily compatible with the broad purpose of the Act, but would instead *serve only to legalize the very extension of credit which the margin requirements seek to prevent and which suits such as this one serve to discipline.* Indeed, brokers could routinely extend credit beyond margin simply by delivering bonds to third-party lenders before they were paid for by the customer, and then immediately commencing suit against the customer for the difference, obtaining a waiver in return for a stay of judgment." 429 F. 2d at 1143.

The "rule" established herein by the Courts below embraces practices which go far beyond the practice the Court in *Pearlstein* refused to endorse.

According to the courts below, brokers can routinely extend otherwise impermissable credit to their customers, having only to show that the customers were familiar with the condition of their account, and thus aware of the extension of credit, and that the customers were aware and familiar with the rules and regulations prohibiting the credit extended, with perhaps a further showing that the customer upon being later confronted with a deficit in his account, was afforded the opportunity to authorize liquidation, or have liquidation conducted without authorization.

or to execute a letter for the ostensible purpose of seeking authority for continuing the extension of credit . . . and the customer having selected the latter . . . only to have such account immediately liquidated and the letter then employed for the purpose of showing ratification of a broker's conduct.

Embracing such a practice defeats *in toto* the purpose of exchange rules and regulations prescribing margin requirements, since such requirements expressly prohibit the extension of *any* credit by broker-members to customers.[33]

The entire thrust of the decisions below rests on the finding that Brooks could have mitigated, if not prevented, the losses to the account by ordering a buy-in of contracts to "cover" the short positions. The flaw in this reasoning is that it ignores entirely consideration of whether Merrill Lynch had both a related and an independent duty to either prevent or mitigate the losses in the account. Apparently the Courts below were persuaded that Merrill Lynch was absolved of any such duty in light of the findings that Brooks by "silence, inaction or neglect" had failed to complain with knowledge of the right to complain, i.e., failed

[33] The margin requirements for acquiring positions in futures as a rule require that five (5) to ten (ten) percent of the value of the contract or contracts on which positions are taken. The broker does not "put up" the balance of the value of the contract, nor does anyone else. Margin levels are set by the Board of Trade according to the actual or anticipated degrees of speculation as to the given commodity (or more particularly contracts for the future delivery of that commodity in or for a given month). Maintenance margins, on the other hand, relate to the price activity relative to a given position. When speculators find themselves unable to meet margin requirements, they are removed from the market. For example, in this instance, Brooks if and when unable to meet a margin call would ordinarily have been compelled to cover his position by buying contracts at a lower price or have the positions liquidated, but for the extension of credit by Merrill Lynch. Thus the extension of credit perforce defeated the market mechanisms employed by the Board in setting margin levels, and the additional market mechanism relating to maintenance margin requirements, injecting unnecessary speculation into the trading of July, 1973 soybean meal contracts.

to take affirmative action to compel Merrill Lynch to close the account and accepting his pre-existing losses.[34]

Merrill Lynch contended successfully that it was relieved from giving a margin call to Brooks under the terms of the commodity account agreement and that it had no obligation to either give such a call or liquidate the account under exchange rules and regulations, thus obtaining the finding that it had no independent duty, or duty as a fiduciary, to prevent or minimize losses in the account.

The provision relied on by Merrill Lynch in the account agreement simply authorizes Merrill Lynch to liquidate positions in the account without notice or additional demand whenever it deems it necessary *for its protection,* listing several instances in which a call or demand would either be unfeasible or impracticable.[35]

[34] Had Brooks insisted that a margin call be given on April 16, 1973, the date his additional funds on deposit were altogether exhausted, his realized losses would have been in excess of $52,000.00. While it can certainly be said that Brooks should have appreciated that he might experience losses in such an amount, it being equally clear that he had at least made provision for adverse movement of the contracts to such extent, it could hardly be said that he or any other investor would be particularly anxious to accept such losses.

It is noted that the prolonged upward price movement in July 1973 soybean meal contracts was generally conceded to be unprecedented, and a possible explanation for the market movement has come to light in light of recent *Wall Street Journal* disclosures concerning manipulation of soybean meal trading on the Chicago Board of Trade, including Federal indictments of a number of soybean meal traders on the CBOT exchange, relating to violations of the Act and exchange rules and regulations.

This is not to suggest that Merrill Lynch was a participant in such manipulative activity and indeed both it and other of its customers may have been victims as well of such activity.

At the same time, it is noted that the price movement of the soybean meal contracts was otherwise inexplicable and Brooks' knowledge of historical activity in this commodity amply justifies his conviction that the price movement would not only return to his favor, but should have done so prior to May 1, 1973.

[35] This provision, in granting Merrill Lynch the right to unilaterally act for its own protection would seem to afford Merrill Lynch a superior means to mitigate, if not prevent, account losses, rather than excusing Merrill Lynch from the duty to do so. See Appendix D-2, third paragraph.

Merrill Lynch then pointed to Rule 209 of the CBOT as standing for the proposition that although brokers are authorized to make demand for additional margin, the failure of the customer to deposit additional funds in response to the demand does not obligate the broker to liquidate the customer's positions. Rule 209 has nothing whatsoever to do with margins, or the margin requirements of the Chicago Board of Trade.[36]

The Court of Appeals misapprehended the subject matter and purpose of Rule 209, and thus its applicability to this case. The Rule provides that Exchange members may ask a customer to provide additional funds *over and above those funds required for margin purposes* as additional protection for the broker in light of his ultimate liability on the contract.[37]

Merrill Lynch justified its handling of the account wholly on its unilateral authority to liquidate without notice as provided in the account agreement and the discretionary authority it claimed is granted by Rule 209, and it was fundamental error for the Courts below to endorse Merrill Lynch's purported reliance on the misconstruction of these two provisions enabling Merrill Lynch not only to engage in some proscribed activity but further relieving Merrill Lynch altogether of its duty to prevent or mitigate account losses.[38]

[36] According to sworn testimony by the Administrator of the Office of Investigations and Audits of the Chicago Board of Trade, Robert C. Thinnes.

[37] These provisions, which are intended merely to provide additional protection to the broker, should not have been so construed as to enable Merrill Lynch not only to evade the express prohibition against extension of credit, but to further excuse it from having to account for its failure to prevent or mitigate those losses for which it has sought and obtained reimbursement hereinbelow.

[38] This error was compounded by the refusal to permit inquiry as to whether Merrill Lynch had engaged in such conduct willfully.

In this context, willfullness is established "if a person 1) intentionally does an act which is prohibited . . . irrespective of evil motive or reliance on erroneous advice, or 2) acts with careless disregard of statutory requirements . . ." *Goodman* v. *Benson*, 286 F 2d 896, 900 (7 Cir. 1961), citing *Eastern Produce Co.* v. *Benson*, 278 F 2d 606, 609 (3 Cir. 1959).

The conduct of Merrill Lynch as broker here should be compared to that of the broker in *Geldermann & Co.* v. *Lane Processing, Inc.*, 527 F.2d 571 (8 Cir. 1975). In this earlier case, the Court of Appeals correctly observed that the broker could be absolved of liability and could recover the account deficit if it were found (1) *that the customer authorized liquidation of the account* or (2) *if the broker was acting pursuant to authority vested in it under the commodity account agreement.* In *Geldermann,* the broker complied at all times with exchange rules and regulations and made prompt and timely margin calls on the customer at each point additional margin funds were due. In that case, the account agreement expressly provided that the customer would at all times maintain in the account the necessary funds to meet margin requirements, even in the absence of a margin call, and further expressly provided that the broker was authorized to liquidate the account if the customer failed to maintain sufficient funds in the account for margin purposes as deemed necessary by the broker for its protection. After the customer failed to maintain the necessary margin in the account in specific violation of the agreement and after the customer further failed on repeated occasions to respond to calls in the prompt and specified manner required by the broker, the brokerage firm liquidated the positions and sought the deficit balance from the customer. There, the *customer* maintained that the provisions of the account agreement and the applicable exchange rules and regulations, including Rule 209, were unconscionable and not enforceable. The Court of Appeals rejected the customer's claims as to unconscionability finding that the provisions of the account agreement and applicable exchange rules and regulations *"promoted the interest and protection of the commission merchants, their customers and the investing public as a whole . . .",* further observing that *". . . a delay in posting the required funds is antithetical to the needs of commission merchants to maintain properly margined accounts at all times."*

In the instant case, it is the broker more than the custimer which neglected the needs of the account, and it is the broker which argued that both the account agreement and exchange rules and regulations to which it is subject are, or would be, unconscionable if too strictly construed, urging instead that such a broad "rule of reason" approach be adopted such that its otherwise proscribed and inexcusable conduct is excused.

The instant case is thus the reverse mirror image of *Geldermann, supra,* presenting the paradox of the broker as the party to a contract prepared by it in which it agreed to perform only under express conditions later contending that it is free to unilaterally disregard those provisions, indeed maintaining not only that such provisions apply solely to the customer, but further that there are no rules, regulations or laws which govern its conduct as broker to customer.[39]

Inexplicably, the Courts below have unequivocally failed to require Merrill Lynch to account for its actions in light of the provisions of the Commodity Exchange Act, and have indeed disregarded that Act entirely, by finding at the same time that rules and regulations promulgated thereunder are of no force and effect.

Is this result consonant with the provisions and objectives of the Act or the intent of either Congress or the designated regulatory authorities?[40]

Hardly.

To the contrary, the result below serves to frustrate the intended purpose of the Act to prevent *speculative abuse,* enabling and excusing a broker's callous disregard of *express regulatory prohibitions,* and simultaneously *abro-*

[39] Cf. Regulations 1.51 through 1.54 promulgated by the Commodity Futures Trading Commission as well as the Commission's Advisory Guideline No. 2 regarding the Contract Market Rules Enforcement Program promulgated by the Commission after its creation under the Commodity Futures Trading Act of 1974.

[40] See *Miller* v. *New York Produce Exchange*, 550 F.2d 762, 768 (2 Cir. 1977).

gating virtually every established principle relating to the *duty of broker to customer.*

Any injury to Brooks or Brooks alone arising out of the underlying conduct of Merrill Lynch, however staggering the injury or damages to Brooks may be, is overshadowed by the harm which has occurred and will continue to occur to *every* investor in the marketplace, and to the *marketplace* itself, in light of the endorsement below of Merrill Lynch's actions, and the result herein can neither be condoned nor permitted to stand.

CONCLUSION

For the foregoing reasons, a Writ of Certiorari should issue to review the judgment and opinions of the United States Court of Appeals for the Fifth Circuit.

Respectfully submitted,

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Of Counsel

WHITE, MCELROY, WHITE,
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CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Petition for a Writ of Certiorari to the Supreme Court of the United States has been made on the other party thereto as follows:

1. On Respondent Merrill Lynch Pierce Fenner & Smith by mailing three (3) copies in duly addressed envelopes with postage prepaid to its attorney of record, Robert G. Vial, Esq., 15th Floor, Republic National Bank Tower, Dallas, Texas 75201.

It is further certified that all parties required to be served have been served by means aforesaid this 1st day of July, 1977.

B. THOMAS MCELROY

Appendix A

United States Court of Appeals,
Fifth Circuit.

Merrill Lynch, Pierce,
Fenner & Smith, Inc.,

Plaintiffs-Appellees,

v.

E. B. Brooks, Jr.,

Defendant-Appellant.

No. 76-1462.

March 14, 1977.

Appeal from the United States District Court for the Northern District of Texas.

Before BROWN, Chief Judge, AINSWORTH, Circuit Judge, and JAMESON*, District Judge.

PER CURIAM:

[1] Essentially this case may be summarized as one where a commodities broker extended credit — over-extended that is — to a sophisticated commodity futures investor who at all times possessed knowledge of his deficient margin account status and who now contends he should not be required to pay back any remaining indebtedness because the extension of credit violated a rule or regulation of the Chicago Board of Trade. To adopt such an argument would permit commodity futures investors knowingly to accept extensions of credit from a broker which violate the Board of Trade's rules or regulations and repudiate losses that ensue or accept profits that follow. The only risk to the investor would be his initial deposit in a margin account, "initial margin", which represents only a fraction of the potential losses or hoped for profits. We do not accept this position and affirm on the basis of the District Court's opinion, *Brooks* v. *Merrill Lynch, Pierce, Fenner & Smith, Incorporated,* N.D.Tex., 1975, 404 F.Supp. 905.

In 1964, Brooks (Investor) initially opened a commodities margin account[1] with Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) so he could buy and sell commodity futures contracts for investment purposes. Unlike many, Investor was not a speculator or diletante. Rather, he has in general great business acumen and possesses in particular extensive knowledge about commodity investing.

During April 1973, Investor utilized his margin account and acquired twenty-four soybean meal futures contracts calling for delivery in July 1973.[2] Unfortunately, his visions of aggrandizement vanished as the price of soybean meal increased which, under Rule 210 and Regulation 1822, ¶ 14 of the Chicago Board of Trade, necessitated that Investor increase the balance in his margin account. This increase is called the "maintenance margin".

Merrill Lynch did not notify Investor on April 12, 1973, the day his margin account became insufficient or "under margined", and not until May 1, 1973 did it demand that Investor deposit the contractually required "maintenance margin". Despite this failure to timely demand, Investor knew at all times of the deficiency in his account. In fact Investor went to Merrill Lynch's local office daily to check on his commodities transactions. Faced with this demand to meet the maintenance margin requirement, on May 7, 1973, Investor agreed in writing to be liable to Merrill Lynch for all amounts, including losses, that might be due under the margin contract.

[1] A margin account allows one to purchase a commodity contract by maintaining only a fraction of the actual purchase price in the margin account.

[2] Investor was in a "short" position. This is when one acquires a contract to sell a commodity for future delivery without actually owning the commodity. If all goes according to an investor's plans, the price of the commodity falls and he is able to purchase the commodity at a price below that in his "sell short" contract. Thus, a profit is realized and is the difference between the "sell short" contract price and the price of the commodity he purchases to satisfy these contracts.

As this letter agreement turned out to be insufficient to the broker's management and no effort was made by Investor to meet the known margin deficiency, Merrill Lynch proceeded on May 9 under its Commodity Account Agreement with Investor to cover Investor's twenty-four contracts and liquidated his margin account at an indebtedness of $198,262. This liquidation occurred later than it could have had the demand for maintenance margin been made on April 12. Rule 209 of the Chicago Board of Trade allows reasonable time to meet such a demand which is interpreted to be one hour in usual circumstances.

Because we affirm on the basis of the District Court's opinion, extended discussion of this case is unwarranted. However, two comments are appropriate. One distinguishes prior Fifth Circuit authority and the other re-emphasizes the salutary nature of Special Verdicts under F.R.Civ.P. 49(a).

[2] In Investor's brief and during oral argument, this Court's attention was directed to two Securities Exchange Act of 1934[3] opinions, *Gordon* v. *du Pont Glore Forgan Incorporated,* 5 Cir., 1973, 487 F.2d 1260, 1262; and *Goldenberg* v. *Bache & Company*, 5 Cir., 1959, 270 F.2d 675, 681, where we declined to allow recovery by a stockbroker from an investor for the amount of the deficiency in his margin account. We believe that regulations promulgated by the Securities and Exchange Commission which have the force and effect of law pertaining to securities sufficiently differentiate those cases from this commodities case in which the futures market of short positions serves economically quite a different function in providing hedges to many facets of the commodity world. As such, they are inapplicable and are of no aid to a knowledgeable investor whose only complaint is that the broker, to investor's knowledge, was extravagant in the credit extended.

[3] Our second comment is to point out once again how valuable the use of special interrogatories with a general

[3] 15 U.S.C.A. § 78a *et seq.*

charge under F.R.Civ.P. 49(a) has been in this case. Here, the jury answered a series of questions submitted by the court that found in critical part that Investor had consented to Merrill Lynch's failure to liquidate his margin account promptly in April or prior to May 9 and that Investor, himself, would not have liquidated the account even if a timely margin call had been given.[4] Based on the jury's own findings and the applicable law, the Judge was able, as we affirm, to enter judgment in favor of Merrill Lynch without divining what basis the jury might have had in a general verdict for either Investor or Broker. In simplest terms, the trial court followed the special verdict procedure of F.R. Civ.P. 49(a). See J. Brown, Federal Special Verdicts: The Doubt Eliminator, 5 Cir., 44 F.R.D. 338 (1969); *Wolfe* v. *Virusky*, 5 Cir., 1972, 470 F.2d 831, 837 (Brown, C. J., concurring); *In re Double D Dredging Co.*, 5 Cir., 1972, 467 F.2d 468, 469 n. 3; *Thrash* v. *O'Donnell*, 5 Cir., 1971, 448 F.2d 886, 889-92; *Little* v. *Bankers Life & Casualty Co.*, 5 Cir., 1970, 426 F.2d 509, 512 (Brown, C. J., concurring); *Horne* v. *Georgia So. & Fla. Ry.*, 5 Cir., 1970, 421 F.2d 975, 980 (Brown, C. J., concurring). Notwithstanding Investor's protestations, no error arises when, as here, a trial court properly utilizes the special verdict device.

[4] When a business person with expertise in commodities trading and with full knowledge of all happenings and their ramifications accepts credit from a broker, as Investor has done, this Court will not relieve this Investor or any investor of an obligation unless singular circumstances exist. That a loss was incurred is not such a circumstance. For the foregoing reasons, the judgment of the District Court is affirmed.

AFFIRMED.

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[4] Questions five and seven elicited these findings. (R. 173-83).

Appendix B(1)

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

MERRILL LYNCH, PIERCE, FENNER
& SMITH, INC.,

Plaintiff

v.

E. B. BROOKS, JR.,

Defendant

CIVIL ACTION NO. CA-3-7898-D

ORDER

The above cause came on for trial before a jury and each of the parties has moved for a judgment in its favor. The court is of the opinion that judgment should be entered in favor of the plaintiff, Merrill Lynch, Pierce, Fenner & Smith, Inc. (hereinafter "Merrill Lynch"), against the defendant, E. B. Brooks, Jr. (hereinafter "Brooks"), for the amount claimed.

By their answers to special interrogatories the jury found that:

(1) Merrill Lynch negligently maintained Brooks' commodity account in an under margin condition (Question 1); and,

(2) Such negligence was a proximate cause of losses in Brooks' account (Question 2);

(3) Merrill Lynch should have stopped its maintenance of Brooks' account in an under margin condition on April 16, 1973 (Question 3);

(4) Merrill Lynch's failure to give Brooks a margin call prior to May 2, 1973, (the date on which a formal call was given) was negligent (Question 4);

(5) Brooks would not have liquidated his account had Merrill Lynch given a margin call prior to May 2, 1973 (Question 5);

(6) Brooks consented to Merrill Lynch's failure to make a margin call prior to May 2, 1973, and to liquidate his account prior to May 9 and 11, 1973, the dates on which the account was liquidated by Merrill Lynch (Question 7).

The issue to be determined it whether Merrill Lynch's conduct in failing to liquidate Brooks' account on April 16, 1973, and in failing to give Brooks a margin call before May 2, 1973, prevents it from recovering the deficit of $198,262.00 that resulted when Brooks' account was liquidated on May 9 and 11, 1973.

Merrill Lynch based its suit on a Commodity Account Agreement (hereinafter "Agreement") between it and Brooks (Plaintiff's Exhibit 1) and a letter dated May 1, 1973, from Brooks to Merrill Lynch's office manager, N. R. Davis (Plaintiff Exhibit 4). The Agreement provided that it "shall be governed by the laws of the State of New York."

When parties agree that the law of a particular State shall govern a contract that law shall apply if it has a reasonable relationship to the agreement. *Aboussie* v. *Aboussie,* 441 F.2d 150 (5th Cir. 1971); *Teas* v. *Kimball,* 257 F.2d 817 (5th Cir. 1958); *Securities Investment Co.* v. *Finance Accept. Corp.,* 474 SW2d 261 (Civ. App.—Houston 1st Dist. — 1971), ref. n.r.e. It is undisputed in this case that Merrill Lynch's office in New York City determined margin requirements for commodity accounts and notified its local offices of the necessity for margin calls. Merrill Lynch's New York office determined that Brooks' account was in an under margin condition and so notified the Dallas office on May 1. The Dallas office in turn notified Brooks on May 2 of the margin condition of his account and made a margin call on him at that time. Since part of the Agreement was performable in New York, there is a reasonable relationship between New York law and the Agreement which justifies enforcing the Agreement according to New York law interpretations and constructions. Throughout

the trial, Brooks' position was that Merrill Lynch's failure to liquidate Brooks' account immediately when it became under margin violated various regulations of the Chicago Board of Trade and New York Stock Exchange, and that such violations precluded Merrill Lynch from recovering any losses it suffered.

Under New York law every violation by a broker of a statutory command or prohibition or of a rule of an exchange does not result in the inability of a broker to enforce civil liability on a customer. *Irving Weis and Co.* v. *Offenberger,* 220 NYS 2d 1001; *Nichols & Co.* v. *Columbus Credit Corp.,* 120 NYS 2d 715. In the case *sub judice* Brooks had full knowledge each day of the margin condition of his account, and he could have covered his short trades which would have stopped his losses. Further, Brooks knew when his account first became under margin, and he knew that he was subject to a margin call at that time. With full knowledge of these facts, Brooks gave a letter to Merrill Lynch on May 7 stating that he "acknowledged the unsecured amount of money" owed to Merrill Lynch and he agreed to pay the "total amount of his indebtedness" when it was determined. These facts coupled with the jury's findings that Brooks would not have liquidated his account had Merrill Lynch made a margin call on him before May 2 and that Brooks consented to Merrill Lynch's failure to make a margin call prior to May 2 and to liquidate his account prior to May 9 and 11 compel the conclusion that under New York law Merrill Lynch's conduct does not bar its right to recover the deficiency in Brooks' account after it was liquidated. The court does not believe that the jury's finding that Merrill Lynch's conduct was negligent alters the result under New York law.

If one assumes arguendo that New York law is not applicable, Merrill Lynch is nevertheless entitled to recover in this case. Brooks relies on *Goldenberg* v. *Bache and Company,* 270 F2d 675 (5th Cir. 1959), and *Gordon* v. *duPont Glore Forgan, Inc.,* 487 F2d 1260 (5th Cir. 1974), in sup-

port of the proposition that a negligent broker is precluded from ever recovering deficits in his customers' account. In each of these cases a stockbroker's customer brought an action for damages suffered when a margin account was liquidated by the stockbroker due to an under margin condition of the account. In each case the stockbroker counterclaimed for a post-liquidation deficiency in the account. In these two cases the stockbrokers were found to have made a tardy margin call on their customers. However, the court declined to grant either party relief, leaving both as it found them by ordering the entry of a judgment that neither party recover from the other. This court is of the opinion that these two cases are factually different from the case *sub judice*.

In *Goldenberg* and *Gordon* the court dealt perfunctorily with the counterclaim of the broker for the deficit that existed in the accounts after they were liquidated. The deficits were small. In neither case was there an express finding that the customer consented to or ratified the negligent conduct of the broker; whereas, in the case at bar the jury specifically found that Brooks consented to Merrill Lynch's failure to make a margin call before May 2, when a call was made and to Merrill Lynch's failure to liquidate his account before May 9 and 11.

In dealing with a principal's liability to his agent Texas courts permit an agent who has acted adversely to the interest of his principal to recover for services performed by the agent where the principal ratifies the wrongful acts of the agent. 2 Tex. Jur. (2d) Agency § 141. Pursuant to general principles of Texas law, Brooks' letter of May 7 constitutes a ratification of any negligent or wrongful conduct by Merrill Lynch in the handling of his account before that date. This letter coupled with the jury finding that Brooks consented to Merrill Lynch's conduct in tardily making a margin call and in the manner in which his account was liquidated should not bar Merrill Lynch, as agent, from recovering from Brooks, as principal, the deficit

that existed after liquidation. The right of Merrill Lynch to recover herein is in keeping with the decision in *Hornblower & Weeks-Hemphill, Noyes* v. *D & G S & M Co.*, 390 F.Supp. 715 (N.D. Tex. 1975), in which Judge William M. Taylor, Jr., confronted with similar facts, permitted a broker to recover a deficit in a margin account despite the customer's claim that the broker should be denied recovery since it had failed to liquidate the account promptly when it became under margined.

A contrary rule would perhaps be in order if we were dealing with an unsuspecting investor. In such instances the broker has a greater responsibility to the customer. But Brooks was a sophisticated and knowledgeable investor who carefully followed his account with greater acumen than that demonstrated by his broker. He was the kind of investor who was able to knowingly consent, as the jury found, to having his account carried. In fact, he did more than acquiesce, he encouraged the carrying of his account. He was always in a position to close his account, but as the jury found, he would not have done so even if Merrill Lynch had made a margin call on him. The thrust of Brooks' position is that Merrill Lynch "injured him" when it heeded his overtures and entreaties.

Brooks argues that Merrill Lynch, having begun to carry the account in violation of the rules, was obliged to carry the account until Brooks ordered its liquidation. In these circumstances the court cannot adopt Brooks' proposed rule, which resembles the adage, "heads I win, tails you lose." In effect the customer would be granted a free ride. After a margin call is required and the broker fails to issue the call, the knowledgeable customer is in an enviable position. If the market continues adversely to the customer's position, he can disclaim his usual responsibility for paying any resulting deficit in his account following liquidation. At the same time if the market "turns around," the customer is able to lay claim to any profit resulting from a favorable market which eliminates the necessities for a margin call.

For the foregoing reasons this court is of the opinion that Merrill Lynch's motion for judgment should be sustained and that Brooks' motion for judgment should be denied. Judgment will be entered in favor of Merrill Lynch for the amount sought in this case.

It is so ORDERED.

Dated this 11th day of December, 1975.

ROBERT M. HILL
United States District Judge

United States Court of Appeals
FIFTH CIRCUIT

EDWARD W. WADSWORTH
CLERK

OFFICE OF THE CLERK

TEL. 504-589-6514
600 CAMP STREET
NEW ORLEANS, LA. 70130

April 7, 1977

TO ALL PARTIES LISTED BELOW:

NO. 76-1462 - Merrill Lynch, Pierce, Fenner & Smith, Inc. v. E. B. Brooks, Jr.

Dear Counsel:

This is to advise that an order has this day been entered denying the petition( ) for rehearing, and no member of the panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 12) the petition( ) for rehearing en banc has also been denied.

See Rule 41, Federal Rules of Appellate Procedure for issuance and stay of the mandate.

Very truly yours,

EDWARD W. WADSWORTH, Clerk

By Susan M. Deavors
Deputy Clerk

/smg

cc: Mr. B. Thomas McElroy
Mr. Robert G. Vial

APPENDIX C-1

Commodity Exchange Act, 7 U.S.C.

5. Resolution declaring dangerous tendency of dealings in commodity futures

Transactions in commodity involving the sale thereof for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest; such transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodity and the products and byproducts thereof in interstate commerce; the prices involved in such transactions are generally quoted and disseminated throughout the United States and in foreign countries as a basis for determining the prices to the producer and the consumer of commodity and the products and byproducts thereof and to facilitate the movements thereof in interstate commerce; such transactions are utilized by shippers, dealers, millers, and others engaged in handling commodity and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price; the transactions and prices of commodity on such boards of trade are susceptible to speculation, manipulation, and control, and sudden unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation, or control, which are detrimental to the producer or the consumer and the persons handling commodity and products and byproducts thereof in interstate commerce, and such fluctuations in prices are an obstruction to and a burden upon thereof and render regulation imperative for the protection of such commerce and the national public interest therein. Sept. 21, 1922, c. 369, § 3, 42 Stat. 999; June 15, 1936, c. 545, § 2, 49 State. 1491.

§ 6a. Excessive speculation as burden on interstate commerce; trading limits; hedging transactions; application of section

(1) Excessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity . . .

§ 6b. Contracts designed to defraud or mislead; bucketing orders; buying and selling orders for cotton

It shall be unlawful for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of (1) any contract or sale of any commodity in interstate commerce, or (2) any contract of sale of any commodity for future delivery made, or to be made, on or subject to the rules of any contract market for or on behalf of any person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or by-products thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof —

(C) Willfully to deceive or attempt to deceive such person by any means whatsoever in regard to any such order or contract, or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person; or . . .

§ 7a. Duties of contrcct markets

Each contract market shall —

(8) enforce all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board

The provisions of the foregoing paragraph do not apply to a non-clearing member who makes his own trades or who on the floor gives his orders for trades which are exclusively for his own account and pays the brokerage thereon.

On the first business day of each month each clearing member who is creditor of any non-clearing member as a result of exchange or member's contracts shall report to the Business Conduct Committee the name of each non-clearing member whose unsecured indebtedness to him is in an amount of one thousand dollars ($1,000) or more. That Committee is authorized to furnish to any clearing member, on written request, the names of all clearing members to whom any specified non-clearing member is indebted as reported hereunder.

A non-clearing member whose unsecured indebtedness to any clearing member is in an amount of one thousand dollars ($1,000) or more shall not submit trades for clearing to any other clearing member without first having procured the written permission of each clearing member to whom he is so indebted and having filed such written permission with the Business Conduct Committee.

The phrase "unsecured indebtedness" as used in this Rule shall mean the amount of indebtedness in excess of collateral security valued in accordance with the provisions of paragraphs numbered 3 and 4 of Regulation 1822.

Failure of the clearing member to report such debits or failure of the non-clearing member to obtain and file the permission as required by the preceding two paragraphs shall be considered an act detrimental to the interest or welfare of the Association under the provisions of Rule 145.

Rule 928(c). The clearing member may call for additional margins at his discretion, but whenever a customer's margins are depleted below the minimum amount required, the clearing member *must* call for such additional margins

as will bring up the account to initial margin requirements and if within a reasonable time the customer fails to comply with such demand (except for unusual circumstances, clearing member may deem one hour to be a reasonable time), the clearing member *must* close out the customer's trades or sufficient thereof to restore the customer's account to required margin status.

(f) violation of this rule shall constitute a major offense.

Regulation 1822. Margin Requirements. *Margin requirements shall at all times be those requirements currently in effect.* Changes in margin requirements shall be effective on all transactions.

§ 1. Transferred to Regulation 1822-A . . .

7. *No member shall extend any credit or give any rebate or gratuity of any kind to any person for the purpose of circumventing or evading minimum margin requirements...*

14. No member mary carry for a customer spreading transactions when the customer's account, figured to the market, would result in a deficit. Minimum maintenance margins required on other transactions are specified in Regulation 1822-A. *When a customer's account drops below the maintenance level,* the account *must* be brought back to initial margin requirements. The failure of a member to close the customer's account *before* it results in such deficit or undermargined condition shall not relieve the customer of any *liability* to the member, nor shall such failure on the part of a member amount to an *extension of credit* to the customer *if the member in the exercise of reasonable care has been unable to close the account without incurring such deficit or undermargined condition.*

15. A member may use his discretion in permitting a customer having an established account to trade during any day without margining each transaction, *provided the net position resulting from the day's trading is margined as required by Rule 210 and Regulations 1822 and 1822-A.* (Emphasis added).

Regulation 1822A Margin on Futures.

(1) *Initial Margins, Other Than Hedging or Spreading.* Under the provisions of Rule 210 the Board hereby fixes the following *minimum initial margins* for futures transactions, other than hedging and spreading transactions:

Soybean Meal . .	$2500 per contract on May 1973 contracts $1500 per contract on July 1973 and forward contracts

(2) *Maintenance Margins* Subject to the provisions of Paragraph 14 of Regulation 1822, maintenance Margin levels on all commitments in future (other than hedging or spreading transactions) shall be as set forth below as a *minimum*:

Soybean Meal . .	$1000 per contract on all contracts

(emphasis added)

Appendix D-1

CODE 91R 6-67

COMMODITY ACCOUNT AGREEMENT

Merrill Lynch, Pierce, Fenner & Smith Incorporated

In consideration of your acting as broker for the undersigned, I hereby consent and agree that:

Any and all transactions shall be subject to the constitution, rules, regulations, customs and usages of the exchange or market (and its clearing house, if any), where executed.

Any and all commodities or contracts relating thereto, now or hereafter held or carried by you for me, (either individually or jointly with others) are to be held by you as security for the payment of any liability of mine to you.

You shall have the right, whenever in your discretion you consider it necessary for your protection, or in the event that a petition in bankruptcy, or for the appointment of a receiver, is filed by or against me, or an attachment is levied against my account(s) with you, or in the event of my death, to sell any or all commodities in my account(s) (either individually or jointly with others) to buy any or all commodities which may be short in such account(s) and to close any or all outstanding contracts, all without demand for margin or additional margin, notice of sale or purchase, or other notice or advertisement, and any such sales or purchases may be made at your discretion on any exchange or other market where such business is then usually transacted, and on any such sale you may be the purchaser for your own account; it being understood that a prior demand, or call, or prior notice of the time and place of such sale or purchase shall not be considered a waiver of your right to sell or to buy without demand or notice as herein provided; and it being further understood that I shall at all times be liable for the payment of any debit balance owing in my account(s) with you upon demand, and that I shall be liable for any deficiency remaining in any such account(s) in the event of the liquidation thereof in whole or in part by you or by me.

I represent that I am more than twenty-one years of age.

All communications, whether by mail, telegraph, telephone, messenger, or otherwise, sent to me at my address as given to you from time to time shall constitute personal delivery to me.

It is agreed that any controversy between us arising out of your business or this agreement, shall be submitted to arbitration conducted under the provisions of the Constitution and Rules of the Board of Governors of the New York Stock Exchange, except however if the controversy involves any Security or Commodity transaction or contract relating thereto executed on an exchange located outside of the United States then such controversy, at the election of either of us, shall be submitted to arbitration conducted under the constitution and rules of such exchange (and if neither of us so elects, arbitration shall be conducted under the provisions of the Constitution and Rules of the Board of Governors of the New York Stock Exchange). Arbitration must be commenced within one year after the cause of action accrued by service upon the other of a written demand for arbitration or a written notice of intention to arbitrate, naming therein the arbitration tribunal.

(OVER)

This agreement and its enforcement shall be governed by the laws of the State of New York.

This agreement shall also inure to the benefit of your successors, by merger, consolidation or otherwise, and assigns, and you may transfer my account to any such successors or assigns.

This agreement shall continue until signed notice of revocation is received by or from me, and in case of such revocation it shall continue effective as to transactions entered into prior thereto.

Date 6/19/67 (Signature) E. B. Brooks, Jr

COMMODITY ACCOUNT AGREEMENT

Appendix D-2

May 7, 1973

Mr. N. R. Davis
Merrill Lynch, Pierce, Fenner & Smith Inc.
Republic National Bank Tower
Dallas, Texas 75201

Dear Mr. Davis:

I hereby acknowledge the unsecured amount of money owed to Merrill Lynch, Pierce, Fenner & Smith Inc. Per our conversation in your office on May 2, 1973, I agree to pay to Merrill Lynch, Pierce, Fenner & Smith Inc. the total amount of this indebtedness.

As of this date the amount has not been determined. I agree that when the amount is determined I will sign a similar letter in which the amount of indebtedness is specified.

I also agree to pay Merrill Lynch, Pierce, Fenner & Smith Inc. interest at the rate of 7½% on the unpaid balance until the total amount of the indebtedness has been paid in full.

Very truly yours,

E. B. Brooks Jr.

E. B. Brooks, Jr.

EBB,Jr.:rv

Goodman

Witness

Attested to:

RHODA WEISMAN Notary Public
in and for Dallas County, Texas
My Commission Expires June 1, 1975

Notary Public

Date May 7, 1973

BEST COPY AVAILABLE

In The

Supreme Court of the United States

October Term 1977

NO. 77-15

E. B. BROOKS, JR.,

Petitioner,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENT IN OPPOSITION

ROBERT G. VIAL AND
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1500 Republic Bank Tower
Dallas, Texas 75201

Attorneys for Respondent

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BRIEF FOR RESPONDENT IN OPPOSITION

TO THE HONORABLE CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Respondent, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") respectfully prays that Writ of Certiorari be denied herein. The decision of the Fifth Circuit is correct and, in addition, this case presents no "special and important reasons" for granting review.

QUESTIONS PRESENTED

1. Was Merrill Lynch under any legal duty whatsoever to liquidate Brooks' commodity position once (or within a reasonable time after) his account became undermargined by virtue of any provisions of the Commodity Exchange Act, rules or regulations of the Chicago Board of Trade, or of the Commodity Account Agreement between the parties?

2. What is the legal effect of the fact finding that Brooks "consented" to the manner in which Merrill Lynch handled his account by his acquiescence and by his execution of the May 7, 1973, letter, acknowledging his indebtedness to Merrill Lynch?

3. Was reversible error committed by the trial court in allegedly failing to submit material fact issues to the jury?

STATEMENT OF THE CASE

A. Nature and Disposition of the Case

This diversity action was brought by Merrill Lynch to recover the balance due in Brooks' commodity account. Brooks defended and counterclaimed, asserting that Merrill Lynch was negligent and/or breached its contractual and fiduciary duties to Brooks in certain particulars and that such negligence and/or breaches caused Brooks to have a debit, rather than a credit, balance upon the closing of his account. Brooks also sought affirmative relief on various theories that Merrill Lynch allegedly violated federal and state antitrust laws. However, Brooks did not appeal from the denial of relief on his counterclaims (Petition for Writ of Certiorari at 7).

The case was tried to a jury and resulted in a Judgment against Brooks for $198,262, plus prejudgment interest at

seven and one-half percent (7½%) per annum from May 11, 1973, to the date of Judgment, December 11, 1975, and post-judgment interest at nine percent (9%) per annum.

B. The Evidence

In 1964 Brooks first opened a commodity trading account with Merrill Lynch (Tp. 354).[1] On or about June 19, 1969, Brooks executed a Commodity Account Agreement, wherein as consideration for Merrill Lynch's acting as his broker in the buying and selling of commodity futures contracts, Brooks agreed to certain terms which would govern the relationship (Tp. 202; Px-1).[2] In early April 1973, Brooks held a short position in twenty-four (24) July 1973 Soybean Meal futures contracts, which were trading on the Chicago Board of Trade ("CBT") (Tp. 43-46; Px-9). A "short" position is established by the customer's instructing the commodity broker to "sell short," or acquire a contract to sell a commodity for future delivery without actually owning the commodity (Tp. 17-18). A speculator, such as Brooks, who sells short in a particular commodity contract hopes that the price of the contract will decrease, so that he can liquidate his position (or "cover") by buying a contract for delivery (satisfying his obligation to sell) at a lower price and thereby realize a profit (Tp. 18). All that a speculator is required to deposit with the commodity exchange (through his broker) in order to establish a commodity position is a small percentage of the total price of the commodity contract on the day the position is acquired (Tp. 59-60). This percentage is known as "initial margin." Although

[1] "Tp." citations are to the Transcript of Proceedings in the Trial Court.

[2] "Px." or "Dx" citations are to the exhibits admitted into evidence by the Trial Court.

Brooks had paid the initial margin required to hold a short position in his July 1973 Soybean Meal contract, on April 12, 1973, because of an increase in the contract price, he was required to deposit additional margin money with Merrill Lynch. This additional margin is called "maintenance margin." Because of some computer error or other error, no formal "margin call," or notice that additional margin is due, was given to Brooks by Merrill Lynch at that time (Tp. 137-39). However, Brooks was fully aware at all times from April 12, 1973, through May 9 and 11, 1973, of the extent to which his commodity account was undermargined (Tp. 188-89, 190, 204-06, 371). He was further aware, having previously deposited maintenance margins for other commodities contracts, that once an account becomes undermargined, the customer must either meet the maintenance margin requirement or liquidate his position (Tp. 70, 197-200, 370). Yet, on May 1, 1973, when the manager of the Dallas-Republic office of Merrill Lynch, N. R. Davis ("Davis"), formally requested Brooks to deposit the required maintenance margin, Brooks asked Merrill Lynch not to liquidate his account and sought additional time within which to make satisfactory arrangements to secure the required maintenance margin (Tp. 201, 203, 377). On May 2, 1973, Brooks orally agreed that he was indebted to Merrill Lynch in a then undetermined amount, being the ultimate difference between the price of 1973 Soybean Meal contracts at the date of liquidation of Brooks' account and the contract equity and margin deposits in Brooks' account (Tp. 52). On May 7, 1973, Brooks evidenced these oral agreements by executing, before a Notary Public, a letter to N. R. Davis, fully setting forth such agreements in writing (Tp. 202).

When Brooks failed to cover his short position, deposit the maintenance margin, or to make any other satisfactory arrangements to put his account in order, Merrill Lynch began to attempt to buy the necessary contracts for the delivery of July 1973 soybean meal to liquidate Brooks' account. Although the market was disorderly, from May 9 through May 11, 1973, Merrill Lynch was able to buy in twenty-four (24) 1973 July Soybean Meal contracts to cover Brooks' short position and liquidate his account, resulting in an unpaid balance of $198,262.00.

REASONS FOR DENYING THE WRIT

Other than simply contending that the decisions of the Trial Court and the Court of Appeals are wrong on the facts of this case, Brooks asserts that the Writ of Certiorari should be granted because: (1) the case involves important questions concerning the applicability of the Commodity Exchange Act, 7 U.S.C. §§ 1-17a (1970) ("CEA"); and (2) the refusal of the courts below to consider that an alleged violation of a Rule 210 of the CBT by a futures commission merchant (or commodities broker) could give its customer a defense to the broker's suit for the deficit balance in the customer's account is somehow in conflict with decisions of this Court and the Second, Seventh and Eighth Circuits. Although it is submitted that the decisions below are eminently correct, nevertheless Merrill Lynch must dispute Brooks' assertion of the "certworthiness" of this case.

1. *No Question of Federal Law Involved.* This case does not involve the CEA or rules or regulations of the Commodity Exchange Commission. True, Brooks' soybean meal futures contracts were traded on the CBT, which was a "contract mar-

ket" designated by Secretary of Agriculture. Pursuant to 7 U.S.C. § 6 (1970), trading in future contracts on a market not so designated by the Secretary of Agriculture would have been unlawful in itself. However, the CBT is not a government agency, but rather a private corporation specially chartered by the State of Illinois. *See Daniel v. Board of Trade of the City of Chicago,* 164 F.2d 815 (7th Cir. 1947). Of course, members of the CBT, such as Merrill Lynch, are indeed bound *to the CBT* to abide by its bylaws, rules and regulations. *See Miller v. New York Produce Exchange,* 550 F.2d 762 (2d Cir. 1977). Brooks has never argued that Merrill Lynch violated specific provisions of the CEA or rules and regulations of the Commodity Exchange Commission. He has only argued that Merrill Lynch violated CBT Rule 210 by carrying Brooks' account for a period of time in an undermargined condition. CBT Rule 210 is neither a statute of the United States nor a rule or regulation of a government agency. Furthermore, even after the Commodity Futures Trading Commission Act of 1974 ("CFTCA"), which significantly broadened federal regulation of commodity futures trading and contract markets (the CEA being considered too weak), no federal law or regulation attempts to regulate margin requirements in commodity futures transactions. And even after the CFTCA (effective long after the transactions at issue and, therefore, not controlling herein) no statutory duty is placed on the *futures commission merchant* (broker) to obey the rules of the various exchanges, although the Commodity Futures Trading Commission may take action against an *exchange* if it is too lax in the enforcement of its own rules. 7 U.S.C. § 21(*1*)(1) (Supp. 1974). Although in 1974 with the CFTCA Congress infringed somewhat upon the self-regulatory status of the commodity exchanges, nevertheless it expressly exempted from the provisions of the CFTCA requiring Commission review and approval of exchange rules those rules "relating to the setting of levels of margin." 7 U.S.C. §§ 7a(12) and 8a(7)(C) (Supp. 1974). Also, margin rules of the exchanges are not included in the CFTCA provisions which require the exchanges to strictly enforce their own bylaws, rules, and regulations. 7 U.S.C. § 7a(8) (Supp. 1974). *A fortiori* there was no federal regulation of commodity futures margins prior to the effective date of CFTCA. Therefore, no federal law has applicability to this case. This is simply a diversity case involving New York and/or Texas law.

2. *The Decision Below is Not in Conflict With Decisions of This Court or Other Courts of Appeals.* Brooks asserts that the decision of the Fifth Circuit herein is in conflict with *Ricci v. Chicago Mercantile Exchange,* 409 U.S. 289 (1973), *Miller v. New York Produce Exchange, supra, Daniel v. Board of Trade of the City of Chicago, supra, Cargill, Inc. v. Board of Trade of the City of Chicago,* 164 F.2d 820 (7th Cir. 1974), *Case & Co. v. Board of Trade of the City of Chicago,* 523 F.2d 355 (7th Cir. 1975), and *Cargill, Inc. v. Hardin,* 452 F.2d 1154 (8th Cir. 1971). The truth is that none of these decisions dealt with the holding of the Fifth Circuit in the case at bar — *i.e.*, even assuming a violation of a Commodity exchange margin rule by a broker, the broker's customer is still liable for the deficit balance in his account upon liquidation. None of the decisions cited as "conflicting" by Brooks arose out of suits between Commodity broker and customer. Obviously then, none were concerned with duties owed by the broker and its customer, one to the other. There is, quite simply, no conflict with any federal decision. Further, as will

be shown below, the decisions of the Trial Court and the Fifth Circuit are in harmony with every commodities decision handed down by state courts on the relevant issue. Accordingly, certiorari cannot be based upon a conflict between circuits or with a decision of this Court. *See Keller v. Adams-Campbell Co.*, 264 U.S. 314 (1924).

3. *There Exists no "Special or Important Reason" for Granting the Writ.* Even assuming arguendo that there exists authority tending to support Brooks' contention that Merrill Lynch's alleged violation of a commodity exchange rule "would ordinarily" provide a customer with a defense, certiorari should not be granted because: (1) the evidence and jury and Trial Court findings conclusively demonstrate that Brooks consented or ratified any alleged improper conduct of Merrill Lynch; and (2) the evidence and applicable law (including the Commodity Account Agreement) establish that CBT Rule 210 was not promulgated for the protection of the customer and that other CBT rules and the Commodity Account Agreement provide that the customer shall be liable for his deficit balance notwithstanding an alleged violation of CBT Rule 210. Thus, whichever way the so-called "conflict" might be resolved, the decisions below are sustainable on independent, alternative non-federal grounds and certiorari is not justified. *See The Monrosa v. Carbon Black, Inc.*, 359 U.S. 180 (1959). Further, if, and to the extent Brooks' position may be dependent upon or at all enhanced by the CFTCA (passed and effective after the occurrence of the transactions at issue herein), certiorari is not called for because the applicable law (the CEA as amended in 1968) is no longer the law of the land. Finally, complaints asserted by Brooks regarding specific evidence, fact findings, and special verdict submission, even if valid (and they are

not), would not justify certiorari. *See United States v. Johnston*, 268 U.S. 220, 227 (1925).

ARGUMENT

1. Merrill Lynch is Not Precluded from Recovering Against Brooks Because of its Failure to Liquidate Brooks' Account Prior to May 9 and 11, 1973

Brooks vigorously argues that the failure of Merrill Lynch to give him a formal margin call prior to May 2, 1973, and its maintenance of his account in an undermargined condition, or failure to liquidate his short position in 1973 Soybean Meal contracts prior to May 9 and 11, 1973, was: (1) negligence (as found by the jury) (R. 177)[3]; (2) a violation of CBT Rule 210, which provides in pertinent part that "No member may accept or carry an account for a customer . . . without proper and adequate margin"; (3) a breach of the Commodity Account Agreement; and/or (4) a breach of fiduciary duties owed to Brooks. Brooks contends that the negligence and proximate cause findings of the jury, the breaches of contractual and fiduciary duties, and the violations of CBT rules and regulations singularly or collectively bar Merrill Lynch from recovering the debit balance remaining in Brooks' commodity account after its liquidation by Merrill Lynch upon Brooks' failure to deposit the required maintenance margin. The following argument will establish that even if Brooks is correct in contending that Merrill Lynch breached legal duties owed to Brooks, under New York law, CBT rules and regulations, and the Commodity Account Agreement, Merrill Lynch is not precluded from recovering the debit balance. Of course, it is

[3] "R." citations are to the record on appeal in the Fifth Circuit.

not admitted that Merrill Lynch breached any duties *owed to Brooks.*

A. Violations of Commodity Exchange Rules Provide No Defense for Brooks

Under the law of New York a violation of a rule of an exchange by a stockbroker or commodities broker not only does not subject the broker to civil liability, but does not provide a defense by the customer to the broker's suit for debt. In *Nichols & Co. v. Columbus Credit Corp.*, 204 Misc. 848, 126 N.Y.S.2d 715 (Sup. Ct. 1953), the commodity broker brought an action to recover the balance due on a customer's account, and the customer defended the broker's action and counterclaimed for damages on the theory that the broker violated Rule 30(a) of the Cotton Exchange by permitting his account to remain undermargined for 20 days. The customer further defended and counterclaimed on the basis that the broker violated Rule 30 of the Cotton Exchange by extending credit to the customer. The court, in directing a judgment in favor of the broker, explained as follows:

> Assuming arguendo that the under-margining was such that the rule required restoration and a closing of the account upon Defendant's failure to restore, and also assuming that Plaintiff failed to take such steps that it reasonably could take in order to get Defendant to restore the impaired margin, I am of the opinion that a violation of the rule by Plaintiff by failing to restore the margin does not entitle Defendant to recover of Plaintiff such loss as Defendant may have sustained by reason of further market fluctuations after the account would have been closed if the rule had been complied with.
>
> Not every violation of even a statutory command or prohibition gives rise to civil liability to one harmed by the violation *or carries with it as a penalty an inability to enforce civil rights arising from acts which would have been lawful except for the statute; and a fortori mere violation of a rule of an exchange does not give rise to such civil liability or entail inability to enforce civil rights*

Id. at 717-18 (emphasis added). Although having already disposed of the customer's counterclaims *and defenses*, the court felt compelled to comment further on the right of a customer to complain of a broker's actions or omissions in such circumstances:

> [A] broker who persistently and intentionally is too indulgent with a customer in respect of margins doubtless will find himself in trouble with public authorities charged with the duty of enforcing such statutes and regulation or with the governing body of his exchange charged with the duty of enforcing the rules of such an exchange; but it seems to me clear that the mere failure of a broker to enforce, strictly and instantly, a margin requirement which the rules of his exchange entitle him to enforce against his customer does not give the customer a cause of action against the broker. The customer is the one who is speculating, not the broker. The customer has the strong financial incentive to watch market fluctuations, and there is no suggestion that he lacks the facilities for keeping himself advised as to them. It also is easy for the customer to protect himself by giving an order to buy or sell when the market reaches a stated point; and I hence think that the customer is the last person in the world who should be heard to complain that his broker has not been sufficiently exacting and stringent in requiring margin.

Id. at 719.

A California case, *DuPont v. Neiman*, 156 Cal. App. 2d 313, 319 P.2d 60, 66 (1957), also holds that a commodities broker

is not precluded from recovering a debit balance in its customer's account, even if it is assumed that the brokers "carried" such account in an undermargined condition prior to liquidation and thereby violated the CBT's rules and regulations:

> We know of no rule of law in this state which would permit a wrongdoer to disaffirm a loss brought on by his own iniquity [failure to pay maintenance margin] unless there be a violation of law involved. Nor is there any law in this state which makes the violation of a rule of an 'exchange' in granting credit to a broker's customer an 'illegal' transaction. It is neither *malum prohibitum* nor *malum in se*. It is manifest that the rules of a trading exchange cannot have the effect of a statutory enactment, and therefore cannot of their own force inject illegality into a transaction.

The rule at issue in *DuPont* was Rule 210 of the CBT. It is submitted that New York courts would concur with the holding and reasoning of *DuPont*.

Another case that stands for the proposition that a broker's failure to enforce margin requirements of an exchange will not prohibit it from recovering the debit balance of the customer is *Goodbody & Co. v. Penjaska*, 8 Mich. App. 64, 153 N.W.2d 665 (1967). Although this is a Michigan case, the law relied upon is predominantly that of New York. In addition, the facts of the case are so strikingly similar to those of the case at bar (although it is a securities, not a commodity futures, case) that its holding and reasoning must be regarded as extremely persuasive herein. In *Goodbody* the broker brought suit against its customer for the debit balance remaining in the customer's undermargined account following its liquidation by the broker. On February 24, 1959, Penjaska began to purchase through Goodbody blocks of Studebaker-Packard stock on margin. The

last block was purchased on January 26, 1960. The stock was highly speculative, and Penjaska made his own decisions as to the purchases and did not rely upon the advice of Goodbody. Beginning with February 3, 1960, the account needed margin, but no margin call was made by Goodbody. The stock continued to decline in value and on March 8, 1960, Goodbody called on Penjaska for $8,500 which Penjaska did not pay. In disallowing Penjaska's *defense* and counterclaim and rendering judgment for Goodbody, the court stated:

> The Defendants maintain in their counterclaim that they suffered damages because they were not sold out sooner. They claim that because Plaintiff violated certain rules of the New York Stock Exchange, that it may not recover in this action. In effect, they say because Plaintiff did not adhere strictly to the rules of the New York Stock Exchange as to margin, that it may not recover. Admittedly, on March 8, 1960, they asked for further time. Admittedly, they were in the office of Plaintiff almost every day, and admittedly they were familiar with the market. At no time did they demand that their stock be sold. Certainly they had as great a duty to protect their account as did the Plaintiff. They did not complain because the Plaintiff was lenient. I doubt if complaint would have been made had the price of the stock advanced during the period of leniency. Had the stock not been sold on March 29, their loss would have been greater. The Defendants are confused by the rules promulgated by the Securities and Exchange Commission and those promulgated by the New York Stock Exchange. There is a vast difference.

Id. at 666-67.

It is submitted that on the basis of the foregoing authorities, Brooks has no defense to Merrill Lynch's suit based on an alleged violation of Rule 210 of the Chicago Board of Trade.

Further, the *Goodbody* case is authority directly in point that the failure to enforce maintenance margin requirements on facts similar to the case at bar does not preclude a broker from recovering the customer's debit balance.

B. Merrill Lynch Was Under No Duty Whatsoever To Liquidate Brooks' Account At Any Time

The jury, in answer to Questions 1, 2, and 3, found that Merrill Lynch was negligent in maintaining Brooks' account in an undermargined condition beyond April 16, 1973, and that such negligence was a proximate cause of the losses in Brooks' account (R. 177-79). Brooks contends that the Trial Court should have entered a take-nothing judgment on Merrill Lynch's claim for debt because of these jury findings. In essence, Brooks is contending that Merrill Lynch's maintenance of his undermargined account after April 16, 1973, or Merrill Lynch's failure to liquidate his account by such date, violated CBT rules and regulations, was negligence, and constituted a breach of contract and fiduciary duty. However, it is the law of New York that a broker is under absolutely no duty to liquidate a customer's undermargined account, although the broker has a right to do so. Before examining the case authority on this issue, the express provisions in the Commodity Account Agreement dealing with this point should be considered as well as CBT Rule 209 and Regulation 1822, which deal with the rights and duties of a broker with regard to its customers' undermargined accounts. The Commodity Account Agreement provides in pertinent part:

> You [Merrill Lynch] shall have the right, *whenever in your discretion* you consider it necessary for your protection, . . . to sell any or all commodities in my [Brooks'] account(s) (either individually or jointly with others) to buy any or all commodities which my be short in such account(s) and to close any or all outstanding contracts, all without demand for margin or additional margin, notice of sale or purchase, or other notice or advertisement, and any such sales or purchases may be made at your [Merrill Lynch's] discretion on any exchange or other market where such business is then usually transacted and on any such sale you may be the purchaser for your own account; it being understood that a prior demand, or call or prior notice of the time and place of such sale and purchase shall not be considered a waiver of your right to sell or to buy without demand or notice as herein provided; *and it being further understood that I shall at all times be liable for the amount of any debit balance owing in my account(s) with you upon demand, and that I shall be liable for any deficiency remaining in any such account(s) in the event of the liquidation thereof in whole or in part by you or by me.*

Rule 209 of the CBT provides in pertinent part:

> 209. *Deposits by Customers.*—A member acting as commission merchant for a customer (member or non-member) may require from such customer a deposit, as indemnity against liability, and subsequent deposits to the extent of any adverse fluctuations in the market price. Such deposits must be made with the commission merchant within a reasonable time after demand, and, in the absence of unusual circumstances, one hour shall be deemed a reasonable time. The failure of the customer to make such deposit within such time, shall entitle, *but shall not obligate,* the commission merchant to close out the trades of the defaulting customer. (Emphasis added.)

Paragraph 14 of CBT Regulation 1822 provides in pertinent part:

> When a customer's account drops below the maintenance margin level, the account must be brought back to initial margin requirements. *The failure of a member to close the customer's account before it results in such deficit or undermargined condition shall not relieve the customer of any liability to the member.* . . . (Emphasis added.)

If there is any doubt as to the effect of these provisions, the opinion in *DuPont v. Neiman* is instructive:

> We must first examine the rules of the exchange in order to determine whether there have been violations thereof. Rule 209 of the Chicago Board of Trade, which relates to the duty of the broker to require initial and subsequent margin deposits, provides in part: 'The failure of the customer to make such deposit within such time, shall entitle, but shall not obligate, the commodity merchant to close out the trades of the defaulting customer.' While this rule gave plaintiffs [brokers] the right to close out defendant's account when he failed to meet margin calls in full, it did not require such action. See Jacobs v. Hyman, 5th Cir., 286 F. 346,351. The discretionary character of this provision clearly indicates that the failure of plaintiffs immediately to close out defendant's accounts when he began to pay less than plaintiffs demanded was not a violation of the rule.
>
> . . . . It is clear from [the language of Regulation 1822, paragraph 14] that the failure of the broker promptly to close the account of a delinquent customer does not affect the latter's liability nor the former's right to recover any deficiency on the account.

319 P.2d at 63.

Thus, the specific language of the Commodity Account Agreement, CBT Rule 209, and Regulation 1822 make it plain that there is no obligation upon the broker to close out a customer's undermargined account.

Even if Merrill Lynch owed a duty *to the CBT* not to carry a customer's account without proper and adequate margin (Rule 210), other CBT rules and regulations could not be clearer in rendering such customer liable for any debit balance remaining after liquidation. Therefore, *the rules and regulations of the CBT themselves* show that the undermargined customer may not take advantage of a lenient broker.

Even if the case law were to the contrary, the rule, regulation, and contract provision would control the relation between the parties on this issue. However, the case authority is in harmony with the rule, regulation, and contract. In *Rubin v. Salomon*, 136 Misc. 527, 241 N.Y.S. 495 (Mun. Ct. 1930), a pre-Regulation "T" securities case, the customer sued the broker for damages for the broker's failure to liquidate the customer's margin account. The customer claimed that the broker by telegram had demanded that the customer make an additional margin payment with the warning that if the margin was not forthcoming, the broker would sell the customer's stock the next day at a certain hour. The customer did not make the margin payment, but the brokers also did not sell the customer's stock as they had a right to do and as they had threatened to do. The customer claimed that the broker's failure to sell the stock caused his loss to be in excess of that which it would otherwise have been had the broker made the sale at the time specified. The court observed that:

> [Customer] makes no claim that he at any time instructed or gave defendants an order to sell the securities. This, of course, he could have done. Can plaintiff insist that his silence shall be construed as an order to sell? I think not. Defendants were under no legal duty to exercise its right to sell the stocks on default of their reasonable request for additional

margin at the time and place contemplated by their notice. They might treat plaintiff's silence as a willingness to have his account carried further in the hope that the market might improve.

A fiduciary relation exists between the broker and the customer. The notice of the brokers' intention to sell is given solely for their benefit. When the brokers do not sell, and choose to rely upon the personal responsibility of the customer, the latter is in no position to complain. The stock is the customer's stock, and is at all times subject to his order prior to redemption or sale. He benefits by any increase in price. He also, necessarily, assumes the risk of depreciation or loss. Should the broker undertake to sell immediately, there is often the question of reasonableness of notice. The broker is not compelled to sell at his peril. For the customer retains the right to order a sale, and the broker must obey the reasonable instructions of the customer, qualified, however, by the rule that a pledgee need not comply with the pledgor's request that he sell the pledged property provided that the refusal to sell is the result of the exercise of the pledgee's honest judgment. . . . These duties and obligations are inherent in the relationship of the parties.

A customer who purchases securities on margin through a stock broker becomes a general owner of the securities, and the broker is only a pledgee for the advances which he makes for the customer's account. The risk of the venture in the purchase of stock on margin is borne entirely by the customer. The customer is under a duty to take and pay for the stock or put up additional margin whenever reasonably requested so to do by the broker. Failing to do this, the broker may sell after a demand for margin is not complied with and notice of intended sale has been given. *The broker is not compelled, however to sell when the margin is exhausted. He may continue to hold the security for the account and at the risk of the customer notwithstanding the customer's failure to*

comply with the demand for additional margin. The broker may thus rely on the credit of the customer who is the owner of the securities and liable for the purchaser price thereof. . . .

In Dos Passos on "Stockbrokers and Stock Exchanges," the author pays (at page 350): 'after the pledgee, however, has called upon the pledgor to pay the debt, and has given legal notice of sale, he is not bound to proceed and sell the same. . . . The rule is that a pledgee of stock or securities is under no obligation to sell the security after default in payment of the debt.'

Id. at 496-97 (emphasis added). The court then noted that the customer's counsel was unable to find any authority for his argument. Counsel did, however, argue that the brokers in this case should be held to a duty to sell, since their demand for margin set forth a certain time and date for the sale of the stock if the margin money was not forthcoming. The Court held that these facts did not justify a change in the established rule:

Plaintiff overlooks the fact that the notice by the stockbroker may well be considered as having been given for his own benefit and protection, and that he may waive his right to sell immediately. If the broker fails to sell at the appointed time or place, the broker may later give the customer notice of sale at another time and place; and, *in the absence of some order or instruction by the customer*, the customer is in no position to complain.

Id. at 498. The court concluded its opinion, saying that: "By his silence a customer may not take advantage of a fluctuating market at the expense of the broker, and thereafter claim that he had repudiated only if the market improved." *Id.* at 499.

Other pre-Regulation "T" New York securities cases which hold that the broker is under no duty to liquidate his customer's

undermargined account include *Crowell v. Cohen*, 151 Misc. 242, 271 N.Y.S. 285 (Sup. Ct. 1934); *Little v. McClain*, 118 N.Y.S. 916, 919 (App. Div. 1909). A Louisiana case provides further authority on this point. In *Kohlmeyer & Co. v. Sobert*, 273 So.2d 884, 886 (La. App. 1973), a commodity futures case, the court stated that:

> Sobert further contends that his broker should have taken action to minimize the substantial losses he incurred over and above the amount that was contained in his margin account. The trial court apparently found this contention equally fallacious and we find no manifest error in this conclusion. No evidence was produced nor have we been cited any authority that would impose a duty upon the broker to take any specified action in an attempt to minimize the customer's losses under the circumstances in this case. The cases cited to us by appellant to support his position. . . are distinguished by the fact that the customer had given his broker specific instructions for actions to be taken not to incur losses in excess of the margin on his account. The record supports the conclusion that no such instructions were given in this case.

In *Pistell, Deans & Co. v. Obletz*, 232 App. Div. 313, 249 N.Y.S. 616 (Sup. Ct. 1931), the court had charged the jury that it was the duty of the broker to have sold the stock of his undermargined customer within a reasonable time after the customer's default. (It is noted that the Trial Court in the case at bar submitted negligence issues essentially inquiring as to Merrill Lynch's reasonableness, or lack thereof, in failing to liquidate prior to May 9 and 11, 1973.) The appellate court reversed, and clearly stated that the broker's discretion in dealing with the customer's margin is not so limited:

> It is not claimed that the Defendant [customer] at any time ordered the Plaintiff [broker] to sell the

> stock. We need not consider what the rights and obligations would be in case of such an order. . . . *The Plaintiff, under the facts in this record owed no duty to the Defendant to sell the stock at any* time. The Plaintiff's right as a creditor and pledgor, as we have already stated, was to hold the stock until it was paid in full or if it saw fit to realize upon the sale of the stock thus held as security, to sell it after reasonable notice to the Defendant. *The Plaintiff's right and obligations under the facts in this case had nothing to do with the sale of the stock within a reasonable time.*

Id. at 621 (emphasis added). In this connection, it is well to note that the Commodity Account Agreement states: "Any and all commodities or contracts relating thereto, now or hereafter held or carried by you [Merrill Lynch] for me [Brooks], . . . are to be held by you as security for the payment of any liability of mine to you." The *Obletz* case is authority that in New York it is reversible error for a trial court to submit negligence issues similar to those submitted in this case, because the broker has *no duty whatsoever* to liquidate an undermargined account.

Therefore, the case law independent of the contract involved in this case, and independent of CBT Rule 209 and Regulation 1822, clearly holds that in the absence of an express stop-loss order requested by the customer, the broker is under no duty to liquidate the customer's account once it becomes undermargined, but instead may look to the personal financial responsibility of the customer. At all times the risk of loss in the account is on the customer. The right to liquidate for one's own protection cannot be translated into a duty to liquidate. The facility to minimize losses was well within the grasp of Brooks in this case, but he refused to enter stop-loss orders. Brooks never specifically requested Merrill Lynch to liquidate his account, and, in fact, the record clearly shows that he

actually requested that his account not be closed out. It is submitted that on the facts of this case, the jury's answers to Questions 1, 2, and 3 of the Trial Court's Charge provide no legal defense whatsoever to Merrill Lynch's right to recover Brooks' debit balance, and that, as a matter of law, Merrill Lynch was not "negligent" and its action or inaction was not the "proximate cause" of Brooks' loss. As stated by the court in *DuPont v. Neiman, supra* at 66:

> In the instant case, defendant [customer] makes no claim that plaintiffs did not follow his orders in the execution of his purchases and sales, nor does he charge that plaintiffs made any fictitious transactions, or violated any exchange rules in the *execution* of his orders. His only claim is that plaintiffs violated exchange rules in granting him credit *after the transactions had been made in accordance with his orders*. In effect, his argument is that the alleged 'illegality' in granting him credit vitiated the transactions made prior to the granting of credit. Cohen v. Rothschild, supra, is not authority for such an argument, nor have we found any decision that is.

This Court will find no authority for such a proposition in Brooks' Petition either.

2. Brooks Is Precluded From Complaining of Merrill Lynch's Actions or Inactions

A. Brooks Consented by Acquiescence

In answer to Question No. 7, the jury found that Brooks consented to Merrill Lynch's failure to make a margin call prior to May 2, 1973, as well as Merrill Lynch's failure to liquidate his account prior to May 9 and 11, 1973. The jury was instructed by the Court that "a person 'consents to' an

omission of another when, by his neglect, silence, or inaction, he fails to complain, with knowledge of the existence of a right to complain, for a period of time in excess of the time within which a person of ordinary prudence under the same or similar circumstances whould have complained." (R. 183). Because the trial court's definition of "consent" suggests waiver, estoppel, and ratification, all of these doctrines will be discussed, but without particular regard to their theoretical differences, since all three operate as a legal bar to Brooks' right to complain of the acts or omissions of Merrill Lynch in this case. There follows first a general discussion of the law of waiver, estoppel, and ratification, as described in *New York Jurisprudence,* and, secondly, a discussion of specific case authority arising out of securities and commodities transactions.

It has been said that "where acts are not performed in a timely manner by one person, another person who participates in such delay cannot take advantage thereof, since such participation constitutes a waiver." 21 N.Y. JUR. *Waiver* §95 (1961). Acquiescence, with knowledge of rights, has been held to be awaiver, and the waiver may result from acquiescence as well as from expressed consent. *See Shernoff v. Schimel,* 112 N.Y.S.2d 333, 342-43 (Sup. Ct. 1952). Acquiescence as a separate defense:

> Is dual in character in that it rests either upon implied ratification or upon equitable estoppel, the former applying when Plaintiff's conduct subsequent to the transaction complained of supports the conclusion that he has by his assent and acquiescence accepted and adopted it, and the other resting upon the principle that a plaintiff who has remained silent and negative when he had an opportunity and was under the duty to speak and act is estopped.

21 N.Y. JUR. *Ratification* § 85 (1961). Other definitions of estoppel include the term "acquiescence":

> It is well settled principle that he who fails to protest when there is a duty and opportunity to speak is deemed to have acquiesced and will not later be heard to complain. . . . When a party with full knowledge, or with sufficient notice of his rights and of all the material facts, freely does what amounts to a recognition or adoption of a contract or transaction as existing, or acts in a manner inconsistent with its repudiation and so as to affect or interfere with the relations and situations of the other parties, he acquiesces in and assents to it and is equitably estopped from impeaching it. . . .

21 N.Y. JUR. *Estoppel* § 35 (1961). As stated in 21 N.Y. JUR. *Estoppel* § 34 (1961): "Graphically stated, he who consents to the sowing is not to be allowed to deny the sower's right to reap."

Specifically with respect to the broker-customer relationship, the rule has been phrased thusly:

> A customer who wishes to repudiate an act of his broker must do so with reasonable promptness. How much time may be take for this purpose is not established by any fixed rule. It has been held in some cases that the disaffirmance must be made within a reasonable time; in others it must be made promptly; in still others, that it must be made immediately. It is clear, however, from the decisions that the customer may not delay very long after the wrongful act has been brought to his knowledge.

MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES 416-17 (1931). *See also Burnham v. Lawson*, 118 App. Div. 389, 103 N.Y.S. 482 (Sup. Ct. 1907 (customer must repudiate within a "reasonable" time). Further examples of the application of this rule are numerous. In *Raisis v. Eisele & King, Libaire Stout & Co.*, 16 N.Y.2d 557, 250 N.Y.S.2d 834 (1965), the Court of Appeals of New York held that a customer ratified the action of his stockbroker in failing to timely disaffirm the broker's "cover" of one of the customer's short sales. In *Sica v. Gimma*, 175 N.Y.S.2d 779 (Sup. Ct. 1958), the court held that the customer ratified the acts of her broker when she received monthly statements clearly delineating all transactions and never complained to the firm about her account. She was precluded from belatedly so complaining at the courthouse. In *Hirsch & Co. v. Pattiz*, 19 App. Div. 2d 607, 241 N.Y.S.2d 124, 125 (Sup. Ct. 1963), the court held that whatever right the customer has to complain of the broker's failure to liquidate the account promptly upon its becoming undermargined was waived. At the time, the customer, although not coming up with the margin money requested, nevertheless asked the broker to "exercise as much discrimination in selling as possible," and "to extend as much consideration as possible." Further, the customer did not object to the subsequent liquidation of his account, which was set forth in detail on the written confirmation received by him. The court stated: "It is clear that whatever contract rights flowed to defendant by incorporation through reference of the rules of the exchange into the trading agreement . . . were unmistakably waived by him." *Id.*

In *Krinsky v. Whitney*, 54 N.E.2d 36 (Mass. Sup. Jud. Ct. 1944), the court held that the customer waived any right to rescind the margin agreement with his broker since he failed to act within a reasonable time to notify his broker of his intention to rescind. The Court stated:

> The highly speculative character of the transaction required prompt notice to the defendants [brokers]. He [customer] could not stand by and withhold

> deciding until it appeared whether the account would prove profitable or otherwise, and in the meanwhile trade on the account at the expense of the defendants. We hold on this record, that the plaintiff by his unreasonable delay lost any right to rescind the agreement and recover what he had paid to the defendants. There was no error in directing verdicts for the defendants.

Id. at 40. Further, in the opinion in *Krinsky* the court noted that the parties agreed that the broker failed to liquidate the customer's account within a reasonable time after the undermargining. The court stated, however, that the customer could no recover from the broker for this failure to liquidate "unless he first proved that he ordered the defendants [brokers] to close the account." Until that event occurred there was no duty on the part of the defendants to close out the account." *Id.*

In *Craig v. Pierce*, 231 App. Div. 159, 246 N.Y.S. 573 (Sup. Ct. 1930), the court held that the customer waived any right to require the broker to liquidate his commodity account at a certain price when the customer, clearly with knowledge of the right to complain, failed to do so within a reasonable time. The customer, in attempting to explain to the broker the reason for his silence, stated that, *inter alia,* he kept silent because he "thought the commodity would rise rapidly and [he] could dispose of it at the same price without any mention of the matter." *Id.* at 579. The court stated that: "One who takes chances with the market in the manner shown by the correspondence in this case should accept the result and not wait until it is too late for anyone to remedy the condition and then attempt to place the loss on others. *Id.* at 579-80.

To the same effect, and giving a clear statement of the law of ratification based on silence by the customer is *Leviten v. Bickley, Mandeville & Wimple, Inc.*, 35 F.2d 825 (2d Cir. 1929). Customer, Leviten, claimed that he had an oral agreement with the brokerage firm not to liquidate his short position in eleven cars of butter for December delivery until he had notice of the necessity of maintenance margin and a reasonable time to comply therewith. The brokerage firm did not deny that it failed to comply with Leviten's wishes, but alleged that he ratified its action by his subsequent conduct. The court explained the doctrine of ratification:

> Ratification has been defined as the subsequent adoption and affirmance by one person of an act which another, without authority, has previously assumed to do for him while purporting to act as his agent. By such ratification the principal absolves the agent from responsibility for loss or injury growing out of the unauthorized transaction, and gives him the same rights to compensation, reimbursement, and indemnity as he would have had, if his act had been previously authorized. . . .
>
> Ratification may be proved, not only by an express assent, . . . but also by implication from the principal's acquiescence or failure to dissent within a reasonable time after being informed by the agent of what he has done, as in *Law v. Cross,* 66 U.S. (1 Black) 533, 539, . . . 'If the price had risen, and Cross had sold it, Law might justly have claimed the profit; and when informed by his agent of what he had done, if the principal did not chose to affirm the act, it was his duty to give immediately information of his repudiation. He cannot by holding his peace, and apparent acquiescence, have the benefit of the contract if it should afterwards turn out to be profitable, and retain a right to repudiate it if otherwise.
>
> The principle of ratifiction has frequently been applied in litigation involving the unauthorizd purchase or sale of stock held on margin by brokers,

> though usually the principal's silence has been accompanied by some affirmative act which strengthens the inference of ratification. . . . But instances are not wanting where, as in *Law v. Cross* the inference arises solely from delay in repudiation.

Id. at 827. The court then had occasion to note the extreme importance of immediate repudiation or complaint by a customer when he is dealing in fluctuating commodity futures:

> The situation was one where delay by the principal in deciding on his course of conduct, if permitted by law, would give him the benefit of a change in the market if it moved in his favor, and put the loss on the agent if it went against him. . . . There was no showing that the appellant did in fact rely upon Leviten's silence; but this is unnecessary, for the doctrine of ratification is independent of estoppel. However, the fluctuating market price of the commodity with respect to which the parties were dealing demonstrates the reasonable foundation of the requirement that the principal act promptly in electing whether to affirm or reject the agent's purchase made on his behalf. The principal by his silence should not be permitted to retain the chance to speculate at his agent's risk.
>
> Ordinarily the question whether a principal has ratified by acquiescence for an unreasonable time after being informed of the agent's unauthorized act is a question of fact for the jury. But the evidence may be such as to make it a question of law for the court.

Id. at 828.

From Brooks' own testimony it is established that he was a sophisticated commodity futures trader, capable of ratifying his broker's actions or omissions (Tp. 206). Brooks had made "independent studies" of the commodity futures market since 1960 (Tp. 186); since 1960 he kept "point and figure" charts to plot price movement of futures contracts (Tp. 186-87); had

priced a seat on the Chicago Board of Trade (Tp. 191-92); was one of the largest and most active commodity futures traders in the Dallas-Republic office of Merrill Lynch (Tp. 198); traded in sufficient volume to be required to submit reports to the Department of Agriculture (Tp. 192-93); had full knowledge of commodity futures margin requirements (Tp. 198); and was reported by credit services to be "among the most wealthy men in Dallas" (Px-22). Specifically, with respect to his trading in July 1973 Soybean Meal contracts, Brooks was in the Dallas-Republic office of Merrill Lynch about one hour per day reviewing market activity (Tp. 189); he relied on his own judgment in buying and selling contracts and all orders in this case were unsolicited (Tp. 187, 188); he knew his margin position and the status of his account everyday from April 12, 1973, to the liquidation of his position and at a given point during a day, notwithstanding the failure of Merrill Lynch to give a formal margin call prior to May 2, 1973 (Tp. 188-89, 190, 204-06, 371); Davis, Merrill Lynch's Dallas-Republic office manager, advised Brooks to use formal stop-loss orders to curb losses in an adverse market, but Brooks refused, terming such devices "poor trading mechanisms" (Tp. 195-97); when Davis confronted Brooks with the undermargined condition of his account, Brooks asked for time to raise the margin money and that he be allowed to maintain his position (Tp. 90, 142, 144, 203, 377); at no time asked to be liquidated (Tp. 69); and he recognized that he was at all times liable to Merrill Lynch for the debit balance in his account upon liquidation (Tp. 202, 206), and he never disaffirmed any action or inaction by Merrill Lynch with respect to his account and never complained that Merrill Lynch breached any legal or contractual duties or CBT rules or regulations (Tp. 375, 377, 378). Of

particular importance is Brooks' response to a critical question posed by the trial court:

> THE COURT: When did you first know in your mind that they were violating the rules?
>
> A. (Brooks): I knew it all along, because, you know, I saw they were—I was well aware of what the rules and regulations were. (Tp. 378).

Therefore, the jury finding (in response to an issue properly framed under New York or Texas law) that Brooks consented by acquiescence to the handling of his account by Merrill Lynch is amply supported by Brooks' own testimony. Under New York law or Texas law, as held by the trial court (R. 196). Brooks is precluded from defending on the bases urged by him because of his failure to disaffirm timely alleged improper acts or omissions of his broker.

B. Brooks Affirmatively Ratified Merrill Lynch's Actions

Apart from the Commodity Account Agreement, Merrill Lynch sued Brooks on the May 7, 1973, letter from Brooks to Davis (Px-4), in which Brooks acknowledged the following:

> Dear Mr. Davis:
>
> I hereby acknowledge the unsecured amount of money owed to Merrill Lynch, Pierce, Fenner & Smith Inc. Per our conversation in your office on May 2, 1973, I agree to pay to Merrill Lynch Pierce, Fenner & Smith Inc. the total amount of this indebtedness.
>
> As of this date the amount has not been determined. I agree that when the amount is determined I will sign a similar letter in which the amount of indebtedness is specified.
>
> I also agree to pay Merrill Lynch, Pierce, Fenner & Smith Inc. interest at the rate of 7½% on the unpaid balance until the total amount of the indebtedness has been paid in full.
>
> Very truly yours,
>
> /s/ E. B. Brooks, Jr.
> E. B. Brooks, Jr.
>
> /s/ V. Goodman
> Witness
>
> Attested to:
>
> /s/ Rhoda Weisman
> Notary Public
>
> Date: May 7, 1973.

Not only did the above-quoted letter of indebtedness provide Merrill Lynch with an independent basis for recovery, but, as found by the trial court: "Pursuant to general principles of Texas law, Brooks' letter of May 7 constitutes a ratification of any negligent or wrongful conduct by Merrill Lynch in the handling of his account before that date" (R. 196). Thus, the trial court properly found that Brooks ratified all prior allegedly wrongful acts or omissions of Merrill Lynch by his reaffirmation of debt on May 7, 1973. However, Brooks has argued that he did not have knowledge of the facts, and of the *law*, required for ratification. It is submitted that the response of Brooks to the trial court's question that he knew "all along" that he had a right to complain of Merrill Lynch's failure to give him a margin call prior to May 2, 1973, and its failure to liquidate his account prior to May 9 and 11, 1973 (Tp. 378), establishes that Brooks did indeed have full knowledge of the facts, and even of his alleged legal rights to complain, at the time he signed the letter of indebtedness.

Brooks had argued at one point in the trial that "the only purpose of that letter was to allow me to retain discretion

in my account and to carry it forth whereby I wouldn't have such a large loss." (Tp. 367). Thus, Brooks implied that he had an agreement with Merrill Lynch that upon his execution of the letter of indebtedness, he could have a "margin-free" ride through the maturity of the Soybean Meal contracts in consideration for his agreement to pay any resulting indebtedness (Tp. 409-10). However, on close questioning, Brooks admitted that there was no such agreement:

> Q. (By Mr. Vial): Then it is your sworn testimony in the United States District Court that you made an agreement with Dick [N.R.] Davis that Merrill Lynch would take the risk of all of this market going to make maybe multi-millions of dollars of losses, but you made this agreement with him that your account would be carried at Merrill Lynch's risk until delivery date —is that right?
>
> A. (By Brooks): We had no agreement.
>
> Q. What?
>
> A. We had no agreement.
>
> Q. I thought you just testified to that. Didn't you just testify in your answer to Counsel's question that— "This is my position in this court"—
>
> A. We did not have an agreement—
>
> THE COURT: Just a minute. It is your position that you did not have an agreement?
>
> A. We did not have an agreement.

(Tp. 380-83).

According to Brooks, after the letter was forwarded to New York, Davis informed Brooks that New York had not accepted the last ditch effort to carry Brooks' account into July without full margin and Davis began to liquidate Brooks' position (Tp. 204). Thus, in Brooks' own words: "There was no agreement" whereby Merrill Lynch would permit Brooks account to continue without full margin. The Dallas-Republic office did send the letter of indebtedness to its New York office in an effort to pacify the exchange, but, in Brooks' own words: "I see no evidence that it . . . satisfied the Chicago Board of Trade requirements" (Tp. 383). Accordingly, New York reported to Davis that "this would not be acceptable . . . to carry the account" (Tp. 204).

When combined with the jury finding of consent, the letter of indebtedness establishes as a matter of law that Brooks impliedly affirmed and ratified Merrill Lynch's handling of Brooks' account to that date. The authorities, rules, and contract provisions already discussed support Merrill Lynch's action in liquidating Brooks' account on May 9 and 11, 1973. There is nothing further about which Brooks could complain.

Brooks' however, does complain that the trial court's finding of ratification via the letter of indebtedness constitutes a denial of trial by jury, because the evidence with respect to the letter raised a fact issue, and no such issue was submitted to the jury. Even if this Court agrees with Brooks that the evidence did raise a fact issue on ratification via the letter of indebtedness (Merrill Lynch says the evidence conclusively demonstrates ratification as a matter of law); nevertheless, under Rule 49(a), Federal Rules of Civil Procedure, Brooks waived his right to a trial by jury on such issue, because he failed to request such an issue and did not object to the trial court's failure to submit one. Rule 49(a) provides:

> (a) Special Verdicts. The court may require a jury to return only a special verdict in the form of a special written finding upon each issue of fact. In that event the court may submit to the jury written questions susceptible of categorical or other brief answer or may

> submit written forms of the several special findings which might properly be made under the pleadings and evidence; or it may use such other method of submitting the issues and requiring the written findings thereon as it deems most appropriate. The court shall give to the jury such explanation and instruction concerning the matter thus submitted as may be necessary to enable the jury to make its findings upon each issue. *If in so doing the court omits any issue of fact raised by the pleadings or by evidence, each party waives his right to a trial by jury of the issue so omitted unless before the jury retires he demands its submission to the jury. As to an issue omitted without such demand the court may make a finding; or, if it fails to do so, it shall be deemed to have made a finding in accord with the judgment on the special verdict.*

(Emphasis added.)

Because Merrill Lynch raised the issue of ratification by the letter in its portion of the Pre-Trial Order (R. 160, 161), and because, as above set out, the evidence (if it did not conclusively show ratification) at minimum raised a fact issue as to ratification via the letter, under Rule 49(a) the trial court was authorized to act as trier of fact and enter its finding without submitting the issue to the jury, in the absence of a request for such an issue by Brooks or an objection to the failure to submit it. Even if the trial court had not found ratification by Brooks' execution of the letter of indebtedness, Rule 49(a) would require this Court to deem such issue as having been found in accordance with the judgment:

> [T]he failure of a party to request the court to submit any issue to the jury which the court may have overlooked is a waiver by that party of his right to trial by jury thereon. . . . And 'as to an issue omitted without such demand, the court may make a finding.'

> When a party fails to request the court to submit an issue and the court omits to make an express finding, the rule goes further to support judgment on special verdicts by implying findings in accord with the judgment rendered.

5A J. MOORE, MOORE'S FEDERAL PRACTICE § 49.03[4], at 2215-17 (1975). *See also Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974).

Although Brooks requested several issues which the trial court did not submit (Supp. Record), and Brooks objected to issues submitted, including Question 7 (pertaining to "consent" by acquiescence) (Tp. 422-29), he never requested (or objected to the failure to submit) an issue as to whether Brooks ratified Merrill Lynch's handling of his account through May 7, 1973, as a result of his execution of the letter of indebtedness, reaffirming his liability for the debit balance in his account. Therefore, Rule 49(a) authorized the Trial Court to make its fact finding, which the court did in favor of Merrill Lynch. Had the Trial Court not done so, the Rule would require this Court to deem such a finding as having been made.

3. No Error Was Committed in the Submission of the Case to the Jury

In his Petition, Brooks has argued that the Trial Court failed to submit material issues to the jury. The requested issues which the Trial Court did not submit may be grouped as follows: (a) breach of contract issues regarding alleged violations of Chicago Board of Trade rules; (b) negligence and fiduciary duty issues pertaining to Brooks' allegation that Merrill Lynch failed to disclose when and under what circumstances it would liquidate his account for failure to meet margin requirements;

and (c) negligence, breach of contract and fiduciary duty issues regarding Merrill Lynch's failure to give Brooks a formal margin call prior to May 2, 1973. For purposes of argument these groups will be discussed separately below.

A. Breach of Contract Issues

Even though the material facts were not in dispute (only the legal consequences flowing therefrom), Brooks requested the trial court to inquire of the jury whether Merrill Lynch carried the account of Brooks without proper and adequate margin and whether such failure was a breach of the Commodity Account Agreement (Requested Issues 3A and 3B); and whether Merrill Lynch breached the Commodity Account Agreement by failing to comply with rules, regulations, customs, and usages of the CBT (Requested Issues 7A and 7B). In essence, these requested issues were formulated by Brooks in order to submit his theory that Merrill Lynch not only violated rules, regulations, and customs and usages of the CBT, but that, by virtue of such violations, Merrill Lynch also breached the Commodity Account Agreement. The basis for Brooks' breach of contract theory is that the Commodity Account Agreement incorporated the rules, regulations, and customs and uages of the CBT by reference, and they thereby became terms of the contract, applicable to both parties equally. This, of course, is erroneous. The Commodity Account Agreement (Px-1) provides that:

> In consideration of your [Merrill Lynch's] acting as broker for the undersigned, I [Brooks] hereby consent and agree that:
>
> Any and all transactions shall be subject to the constitution, rules, and regulations, customs and usages of the exchange or market (and its clearing house, if any), where executed.

There is no blank for a representative of Merrill Lynch to sign. Acceptance by Merrill Lynch is accomplished upon performance as a broker. The obligations and agreements undertaken are exclusively those of Brooks. His consent that all transactions shall be subject to the rules of the exchange where the order is executed is nothing more than his assent to the method of execution of transactions on the floor of the exchange. As discussed below, the CBT margin rules are for the benefit of the brokers to insure broker solvency, and are in no way designed to protect the individual customer. But even if it could be said that Merrill Lynch violated a rule, regulation, or custom and usage of the CBT, the Commodity Account Agreement specifically says that:

> You shall have the *right* whenever *in your discretion* you consider it necessary for your protection, or in the event that a petition in bankruptcy, or for the appointment of a receiver, is filed by or against me, or an attachment is levied against my account(s) with you, or in the event of my death, to sell any or all commodities in my account(s) (either individually or jointly with others) to buy any or all commodities which may be short in such account(s) and to close any or all outstanding contracts all without demand for margin or additional margin, notice of sale or purchase, or other notice or advertisement, and any such sales or purchases may be made at your discretion on any exchange or other market where such business is then usually transacted, and on any such sale you may be the purchaser for your own account; it being understood that a prior demand, or call, or prior notice of the time and place of such sale or purchase shall not be considered a waiver of your right to sell or to buy without demand or notice as herein provided; and it being further understood that I shall at all times be liable for the payment of any debit balance owing in my account(s) with you upon

> demand, and that I shall be liable for any deficiency remaining in any such account(s) in the event of the liquidation thereof in whole or in part by you or by me. (Emphasis added.)

Thus, Merrill Lynch had no *duty* to liquidate Brooks' account (under the Commodity Account Agreement and CBT Rule 209 and Regulation 1822, ¶ 14) at anytime after it became undermargined. So, "carrying" Brooks' account in an undermargined condition (which is only semantically different from a failure to liquidate), even if it could be said to be violative of CBT Rule 210, could not be a breach of the Commodity Account Agreement. Further, Brooks has never pleaded or presented evidence that Merrill Lynch waived any of *its* rights under CBT rules and regulations and the Commodity Account Agreement. From the record it is apparent that the trial court properly treated alleged violations of CBT rules and breaches of contract on undisputed material facts, as issues of law (Tp. 152), and correctly refused to hold that violations of CBT rules, if any, gave Brooks a defense (see pp. 10-13 *supra*), or that Merrill Lynch's handling of the Brooks' account breached any provisions of the Commodity Account Agreement.

Finally, assuming that the Trial Court committed error in omitting material issues from its charge, such error is clearly harmless error under Rule 61, Federal Rules of Civil Procedure, because both the jury and the Trial Court found that Brooks ratified all alleged rule violations and contract breaches by Merrill Lynch.

B. Issues Regarding Alleged Failure to Disclose Procedures in the Event of Failure to Meet Margin Requirements

Brooks contends that Merrill Lynch failed to disclose when

and under what circumstances his account would be liquidated upon failure to meet margin requirements, and that such alleged failure to disclose was negligence and/or a breach of fiduciary duty owed to him by Merrill Lynch. He complains that the trial court committed reversible error in not submitting the material fact issues underlying this defensive theory to the jury. It is submitted that the evidence conclusively established that Merrill Lynch did not fail to disclose the procedure to be followed upon undermargining, and that Brooks was well aware of all alternatives available to him and of the consequences of each. The Commodity Account Agreement very clearly set out Merrill Lynch's rights to liquidate Brooks' account if it became undermargined, even without the necessity of a margin call or any notice whatsoever (Px-1). Brooks admitted that he signed the Commodity Account Agreement (Tp. 202). CBT Rule 209 and Regulation 1822, ¶ 14, as interpreted by the courts (see *supra* at pp. 14-16), are in harmony with the Commodity Account Agreement in giving Merrill Lynch broad rights to require additional margin deposits and to liquidate undermargined accounts, and in specifying that the forbearance to exercise such rights will not affect the customer's continuing liability for any debit balance in his account. Brooks stated that he was familiar with the rules and regulations of the CBT (Tp. 378). In addition, the Commodity Account Agreement states that "a prior demand [for margin], or call, or prior notice of the time and place [of liquidation] shall not be considered a waiver of your [Merrill Lynch's] right [to liquidate an undermargined account] without demand or notice." Brooks has never alleged in the trial court or in this Court that Merrill Lynch waived its rights under CBT rules and regulations or the Commodity Account Agreement. The Court is also referred to

the New York cases cited and discussed *supra* at pp. 17-19, which hold that even when the broker gives its customer misinformation as to the time, place, and circumstances of liquidation of an undermargined account, the customer may not complain.

Therefore, it is submitted that, as a matter of law on the undisputed facts, Brooks knew that Merrill Lynch had the right to liquidate his account at any time, or *not* to do so, in its discretion; so, he may not claim breach of fiduciary duty or negligence because Merrill Lynch bent over backward to salvage Brooks' position or cut his losses — something he refused to do himself.

C. Issues Regarding the Late Margin Call

Brooks contends that the Trial Court committed reversible error in not submitting issues to the jury inquiring as to whether Merrill Lynch's failure to give Brooks a formal margin call prior to May 2, 1973, was negligence, a breach of contract or fiduciary duty, and of CBT Rules and regulations. CBT rules and regulations and provisions of the Commodity Account Agreement giving Merrill Lynch the unqualified right to liquidate an undermargined account (without notice or call) have been previously discussed. These rules and contract provisions clearly eliminate any defense Brooks might otherwise have had based on a late margin call. Further, the trial court did submit issues on the margin call question. In answer to Question No. 4, the jury found that Merrill Lynch was negligent in failing to give Brooks a margin call prior to May 2, 1973 (R. 180). However, in answer to Question No. 5, the jury found that Brooks would not have liquidated his account prior to May 2, 1973, even if he had received a margin call (R. 181). Of

course, the reason the jury answered Question No. 5 as it did is that Brooks admitted he knew the status and condition of his account at all times, that he could have closed out his account and cut his losses at any time, but did not. Thus, the undisputed evidence and the jury's answer to Question No. 5 shows that a late margin call did not deprive Brooks of *notice* of the undermargined status of his account; nor did a late margin call cause him to miss an opportunity to cut his own losses.

Finally, the jury, the Trial Court and the Fifth Circuit found that Brooks ratified all alleged rule violations, negligent acts or omissions, and breaches of contract or fiduciary duty by Merrill Lynch by his acquiescence and his execution of the May 7, 1973, letter of indebtedness. Under Rule 61, Federal Rules of Civil Procedure, any error of the Trial Court in failing to submit further issues on the late margin call question was harmless.

4. Regulation "T" Cases Distinguished

As has been noted above, Brooks misplaces reliance on cases such as *Miller v. New York Produce Exchange, supra,* which discussed a commodities broker's duty to the *commodities exchange* and not the broker's duty to its customer under exchange rules. This is a key area of confusion in Brooks' Petition. But there is another misleading aspect to Brooks' contentions. Brooks continues to rely (although not quite as heavily in his Petition as in his Brief and argument in the Court below) on *Goldenberg v. Bache & Co.*, 270 F.2d 675 5th Cir. 1959), and *Gordon v. duPont Glore Forgan, Inc.*, 487 F.2d 1260 (5th Cir. 1973). Actually, both of these cases illustrate ratification by a securities customer by acquiescence and failure to timely disaffirm a broker's acts or omissions.

However, because the Fifth Circuit in *Goldenberg* and *Gordon* also refused to permit the brokers to recover on their counterclaims because of their own violations of Regulation "T". Brooks has cited both cases as authority for urging this Court to simply leave the parties where they were prior to resort to the Courts. Although these cases are distinguishable on other grounds, it should be noted at the outset that the public policy behind Regulation "T" and the federal securities laws generally has absolutely no bearing on this case. Further, Regulation "T" speaks only to initial margin, and in no way purports to regulate maintenance margin. *See Carras v. Burns*, 516 F.2d 251, 260 n.6 (4th Cir. 1975). Neither *Goldenberg* nor *Gordon* was a commodity futures case and neither involved New York law. In fact, no state law was applied at all with respect to the brokers' counterclaims. Federal law was applied to determine the effect of the brokers' acts or omissions. The alleged violations of duty by the brokers in *Goldenberg* and *Gordon* were more than violations of rules or regulations of commodity or stock exchanges, but were violations of Regulation "T", which has the force of law, pursuant to the Securities Exchange Act of 1934. The case at bar is not a Regulation "T" case. No violations of federal securities law were alleged or proved. In fact, no violations of any provision of the Commodity Exchange Act were proved. Only state law is relevant herein.

As the Comptroller General reported to Congress in 1974 when Congress was considering amending the CEA:

> The need for CEA [the Commodity Exchange Authority] or another Federal agency to have authority to establish commodity margin requirements has been the subject of much controversy and misunderstanding, primarily because commodity margins have been compared with security margins, when, in fact, they are not comparable. Commodity margin is the amount of money which the buyer or seller of a futures contract deposits with its [Futures Commission Merchant] FCM to guarantee performance on the contract. The margin is required to protect the FCM against losses incurred by a customer due to adverse price movements. It is not a partial payment on the futures contract. The FCM has to make settlement each day for profits or losses incurred by its customers. The margin money, plus or minus any gains or losses on the customer's trades, is returned to the customer when his account is closed. In a normal market, commodity margins are generally less than 10 percent of the value of the contracts bought.
>
> Security margin is directly related to the amount of credit a broker is permitted to extend to customers for buying securities. This amount of credit is regulated by the Board of Governors of the Federal Reserve System and is 50 percent or more of the value of the securities bought.

INTERIM REPORT OF COMPTROLLER GENERAL ON THE COMMODITY EXCHANGE AUTHORITY AND ON COMMODITY FUTURES TRADING, 120 CONG. REC. 7527 (daily ed. May 9, 1974). *See also id.* at 7525:

> The idea of giving the futures trading authority to SEC was rejected by the House Committee on Agriculture and others as having little advantage and many disadvantages. The principal advantage was that SEC has an existing regulatory structure and is supervising some brokerage firms that also trade in the commodity futures markets. The overriding disadvantage was the pronounced difference between CEA and SEC in fundamental orientation and purpose, which would pose different regulatory problems. For example, a futures contract is not a security; hence, the laws applicable to securities would not apply to futures contracts.

Margin requirements set by commodity exchange rules are established primarily *to protect the solvency of brokers* by assuring adequate security for the performance of the futures contract, for which the broker is responsible to the exchange, which the broker is responsible to the exchange, whether the broker's customer defaults or not. (Tp. 235-36). Therefore, since such rules were not promulgated for the protection of customers, they create no civil right of action and no defense to a broker's action for debt. *See Carras v. Burns, supra* at 260. *See also Rosee v. Board of Trade of City of Chicago*, 311 F.2d 524, 525 (7th Cir. 1963); U.S. DEP'T OF AGRICULTURE, MARGINS, SPECULATION & PRICES ON GRAIN FUTURES MARKETS 176, 189, 190-200 (1967); Wolff, *Comparative Federal Regulation of the Commodities Exchanges & The National Securities Exchanges*, 38 GEO. WASH. L. REV. 223, 242-44 (1969) ("there is no indication that government-imposed margins could effectively serve functions other than protection of broker solvency, a goal successfully maintained under the present industry structure"); Note, *Civil Liability of a Broker for Failure to Enforce Margin Requirements*, 10 WILLAMETTE L.J. 72, 85 (1973). This approach was obviously adopted by Congress in 1974 when in the CFTCA, it expressly refused to exert government regulation over margin transactions on commodities exchanges. *See* 7 U.S.C. §§ 7a(12) & 8a(7)(c) (Supp. 1974). Instead, market and broker solvency was and is protected via stringent minimum financial requirements on futures commission merchants and daily settlement and reporting procedures *at the contract market level*, not in the area of broker-customer margins. *See* 7 U.S.C. §§ 6f, 7a(9) (Supp. 1974); 17 C.F.R. § 1.17 (1976).

Therefore, the margin rules of commodity exchanges do not

now, and certainly did not prior to the CFTCA, have the force of law as do rules and regulations promulgated by the Securities and Exchange Commission or the Federal Reserve Board pursuant to federal securities laws. Brooks is accordingly unaided by overriding Congressional purposes reflected in such laws.

CONCLUSION

For the foregoing reasons, Respondent respectfully requests that the Petition for Writ of Certiorari be denied.

Respectfully submitted,

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PROOF OF SERVICE

Two copies of this Brief in Opposition have been served upon Petitioner, E. B. Brooks, Jr., by hand-delivering same to his attorney of record, Mr. B. Thomas McElroy, WHITE, McELROY, WHITE, SIDES & RECTOR, 2505 Republic National Bank Tower, Dallas, Texas, 75201, on this .... day of August, 1977.

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